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CORPORATE GOVERNANCE AND EXECUTIVE COMPENSATION: EVIDENCE FROM JAPAN

Robert J. Jackson, Jr.* & Curtis J. Milhaupt**

Lawmakers around the world are now urging corporations to adopt governance and executive pay standards drawn largely from the American corporate law context. Yet little is known about how corporate governance actually influences executive compensation decisions outside of the United States—and whether adoption of these standards is likely to be desirable for investors abroad.

In this Article, we take advantage of a recent change in Japanese law to provide the first direct empirical evidence on executive pay in Japan. The evidence provides striking detail on the amount and structure of Japanese executive compensation. The data point to a previously unappreciated link between corporate governance and executive pay in Japan and indicate that several trends familiar to the U.S. compensation landscape have begun to take hold in Japanese firms. Our findings suggest that lawmakers and firms should take careful account of the relationship between

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governance and pay before importing governance standards from abroad.

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I. INTRODUCTION

In the aftermath of the recent financial crisis, the finance ministers of all G-20 nations called on the Financial Stability Board to propose global standards on compensation structures that would govern the pay of bank executives around the world.[1] Although the standards are limited by their terms to banker pay, practitioners have made clear that the G-20's call for convergence on compensation practices has already had significant influence for firms across the global economy.[2] The standards draw heavily on the U.S. experience with executive compensation, favoring arrangements designed to address the agency problems that, some have argued, influence pay at large American public companies. Yet the standards, like most of the theoretical literature developed by academics, do not take account of the profound differences in corporate governance around the world—and the potential influence of those differences on executive pay.

In this Article, we contribute to the literature on the relationship between governance and executive pay by providing the first empirical evidence on the magnitude and structure of the compensation packages of Japan's most highly paid executives. Taking advantage of a recent change in Japanese law that requires, for the first time, extensive disclosure on the compensation of individual executives at Japanese public firms, we develop a proprietary, hand-drawn

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1 *See* FINANCIAL STABILITY FORUM, FSF PRINCIPLES FOR SOUND COMPENSATION PRACTICES 1 (2009).

2 CALVIN JOHNSON & KATY BENNETT, WATSON WYATT WORLDWIDE, EXECUTIVE PAY PRACTICES AROUND THE WORLD 3 (2009) (describing a "thrust in recent years toward convergence [in] . . . executive pay practices.").

database including detail on the amounts and elements of executive pay for Japan's highest-paid managers. The evidence provides striking new detail on executive pay in Japan—and new insights on the relationship between corporate governance and top managers' compensation.

First, we find, consistent with previous work, that Japanese managers generally receive considerably less total pay than U.S. executives. Second, we find, also consistent with previous work, that the structure of executive pay in Japan relies far more heavily on payments unrelated to performance, such as salary, than do pay structures in the United States. But the closer look permitted by our data suggests an important divergence in pay practices among Japanese firms—depending on whether the firm features the traditional Japanese corporate governance approach or a committee-based structure more familiar to American corporate law.

For example, we find that executives at firms governed in the U.S. style receive far more pay in the form of performance-based elements such as bonuses and stock options than their counterparts at traditional firms. We also find that the relationship between firm size and executive pay—a relationship familiar to the U.S literature on executive pay—is far less strong at traditionally governed Japanese firms than it is at firms governed by committees. Moreover, we find that at firms with traditional board structures, the gap between the compensation of top executives and the average member of the board of directors is relatively small, and shrinks as the firm grows in size. By contrast, at companies with committees, the gap between top executives and the average director grows considerably along with firm size.

Similarly, the influence of global markets in executive services is a critical determinant of executive pay inside Japan. On average, non-Japanese executives, whose pay is determined by international trends in executive pay, earn about forty percent more than Japanese executives, even controlling for differences in firm size and performance. And the structure of compensation is also profoundly influenced

by global pay practices. Non-Japanese executives receive fifty percent more of their compensation in the form of stock options in comparison to their Japanese counterparts.

On balance, our findings suggest a considerably more nuanced pattern of Japanese pay practices than previous analysis has exposed. Most intriguingly, we find preliminary evidence that Japanese firms that have adopted U.S. board structures have also adopted U.S. pay practices, if on a more modest scale. We consider whether this trend may result from simple endogeneity, signaling, familiarity with a standard set of off-the-rack governance practices, or a causal relationship between governance structures and executive compensation.

Finally, our data provide new insights on the continuing debates over the effects of rapid recent adoption of corporate governance reforms in Japan. We conclude that the data are inconsistent with the view that these reforms have had no effect on the actual governance of Japanese public companies. We also note, however, that the evidence provides little support for the view that Japanese managers have adopted with unambiguous zeal all of the features of the shareholder-centric corporate governance model of the United States.

The Article proceeds as follows. Part II describes the relationship between corporate governance and executive pay in the United States and Japan. Part III describes the first direct evidence on top executives' pay in Japan. In Part IV, we consider the implications of our findings for corporate governance and executive compensation standards around the world. Part IV concludes.

II. CORPORATE GOVERNANCE AND EXECUTIVE PAY

The bulk of the extensive literature on executive compensation has focused on the pay bargains struck between boards of directors and top executives at U.S. public

companies.[3] Because stock ownership in these firms is widely dispersed, each shareholder owns too small a stake to make monitoring of directors worthwhile.[4] Moreover, executives can influence whether directors retain their seats on the board.[5] Thus, there is an agency problem: director-agents may have reason to favor executives' interests over those of their shareholder-principals, skewing executive-pay bargains away from optimal arrangements.[6] Extensive empirical evidence on executive pay at U.S. public companies has been marshalled in support of both positions.

By comparison, the pay-setting process in Japanese corporations has received relatively little attention. Traditionally, Japanese firms have been overseen by a board of "statutory auditors" who provide relatively weak constraints on insiders' influence over directors and their bargains with executives over pay.[7] More recently, however, Japanese companies have been given the option to choose an American-style governance system in which a committee of independent directors is responsible for executive compensation decisions.[8] No previous work, however, has evaluated empirically whether this governance choice is

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3 *See, e.g.*, Kevin J. Murphy, *Executive Compensation*, *in* HANDBOOK OF LABOR ECONOMICS 2485, 2486 (Orley Ashenfelter & David E. Card eds., 1999) (describing this literature and noting that growth in the number of academic articles on executive pay has outpaced the growth of executive compensation itself).

4 *See, e.g.*, ROBERT C. CLARK, CORPORATE LAW 390–92 (1986) (describing shareholders' rational apathy).

5 For a forceful articulation of this point, see, for example, JAY W. LORSCH & ELIZABETH MACIVER, PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARDS 20 (1989).

6 For the seminal articulation of agency problems in U.S. public companies more generally, see generally ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932) (arguing that management and directors—by virtue of their day-to-day involvement—have the ability to manage companies' resources to their own advantage absent effective shareholder scrutiny).

7 *See* Ronald J. Gilson & Curtis J. Milhaupt, *Choice As Regulatory Reform: The Case of Japanese Corporate Governance*, 53 AM. J. COMP. L. 343, 348 (2005).

8 *Id.* at 344.

associated with different bargains over compensation for Japan's top managers.

A. Theory and Evidence from the United States

At large U.S. public companies, directors bargaining over executive pay must reconcile the competing interests of shareholders and executives. Shareholders prefer that managers be paid no more than is required to induce optimal effort and that pay structures incentivize executives to maximize shareholder wealth, for example through the use of bonuses, grants of stock, or other arrangements that tie pay to firm value.[9] Executives, on the other hand, prefer compensation that is less risky, such as cash payments of predetermined value.[10] Whether the directors charged with setting managers' compensation favor the interests of executives over those of shareholders has been the subject of considerable debate.

1. Competing Theories on Executive Pay

Scholars have focused on two potential theoretical explanations for executive pay practices in the United States. The first, sometimes called the "optimal contracting" approach, holds that markets in capital, products, and corporate control induce directors to pursue the executive-pay deal that shareholders prefer.[11] While proponents of this view concede that markets may occasionally leave room for executive-pay arrangements that depart from shareholder preferences, in general, bargaining between directors and executives produces the pay package that is in shareholders' best interests.

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[9] For the classic articulation of this point, see Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308–10 (1976).

[10] *See* STEVEN BALSAM, AN INTRODUCTION TO EXECUTIVE COMPENSATION 80 (2002).

[11] *See* Frank H. Easterbrook, *Managers' Discretion and Investors' Welfare: Theories and Evidence*, 9 DEL. J. CORP. L. 540, 543 (1984).

Adherents of the second approach, the "managerial power" view, contend that market forces are insufficient to overcome the strong influence that top executives wield over directors at large U.S. public companies.[12] Among other considerations, executives at U.S. public companies retain some influence over whether a director is nominated for reelection on the company proxy, and thus whether the director is overwhelmingly likely to retain her seat on the board.[13] Meanwhile, these directors own very little of the company's stock, and thus internalize very little of the costs of executives' compensation. For directors, then, the costs of capitulating to executives' pay demands are small, while the costs of resisting those demands may be large. Thus, these theorists argue, directors may approve executive-pay packages that stray significantly from the optimal bargain for shareholders.

Although the optimal-contracting view has long been the dominant approach in financial economics, more recently the managerial-power view has been increasingly cited as a basis for regulatory change in the United States. For example, the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act requires that U.S. public companies provide shareholders with a nonbinding vote on executive compensation.[14] Scholars taking the optimal-contracting

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[12] *See, e.g.*, Richard A. Lambert et al., *The Structure of Organizational Incentives*, 38 ADMIN. SCI. Q. 438, 441–42 (1993) (providing an early description of this view); Lucian Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 764–65 (2002).

[13] Nominees listed on the company's proxy statement are essentially assured election, and although the principal U.S. securities exchanges require those nominees to be selected by an independent committee, *see* Orders Relating to Equity Compensation Plans, Exchange Act Release No. 34-48108, 68 Fed. Reg. 39,995 (June 30, 2003), it is well-known that executives nevertheless retain considerable influence over the identity of the director nominees listed in the corporate proxy. *See* Martin Lipton, *The Millennium Bubble and Its Aftermath: Reforming Corporate America and Getting Back to Business*, M&A LAW., July–Aug. 2003, at 1, 4.

[14] Dodd-Frank Wall Street Reform and Consumer Protection Act § 951, 15 U.S.C. § 78n-1 (2012).

view have argued forcefully that much empirical evidence on executive pay cannot be explained by the managerial-power theory, and thus that the prospect of executives' dominance of the boardroom is an insufficient basis for changes in corporate governance.[15]

2. Empirical Evidence

Executive pay in the United States has been the subject of considerable empirical study, and this evidence has repeatedly been marshalled in support of both the optimal-contracting and managerial-power theories.[16] While both sides of the debate over executive pay cite empirical work, empirical study in this area has yielded at least three important insights with which proponents of both schools generally agree.

First, the empirical literature establishes that the amount of the chief executive officer (CEO)'s compensation in U.S. public companies is significantly positively correlated, both economically and statistically, with firm size.[17] And, because the large American public company has grown substantially during the last two decades, the magnitude of CEO pay has also risen.[18] While there is considerable debate as to whether managerial power might also explain some of the growth in CEO pay, most commentators appear to agree

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15 *See* Stephen M. Bainbridge, *Executive Compensation: Who Decides?*, 83 TEX. L. REV. 1615, 1630 (2005).

16 *Compare, e.g.*, LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION ch. 6 & n. 3 (citing John Core et al., *Corporate Governance, Chief Executive Officer Compensation, and Firm Performance*, 51 J. FIN. ECON. 371, 372–73 (1999)), *with* Bainbridge, *supra* note 15, at 1630 (citing M. Todd Henderson & James C. Spindler, *Corporate Heroin: A Defense of Perks, Executive Loans, and Conspicuous Consumption*, 93 GEO. L. J. 1835 (2005)).

17 *See* Xavier Gabaix & Augustin Landier, *Why Has CEO Pay Increased So Much?* 2 (MIT Dep't of Econ. Working Paper No. 06-13), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=901826.

18 *See* BEBCHUK & FRIED, *supra* note 16, at 1.

that growth in firm size explains at least some of the growth in executive pay.[19]

Second, the literature makes clear that as the magnitude of executive pay at large U.S. public companies has risen, the link between pay and performance has also grown stronger.[20] For example, standard measures used in the financial economics literature to estimate the effects of changes in firm value on CEO wealth, such as the CEO's exposure to the firm's stock price through ownership in stock and stock options, have risen considerably.[21]

Finally, and far more controversially, the empirical literature suggests that certain governance features may be associated with the magnitude and structure of executive pay. For example, one frequently-cited study of the relationship between director characteristics and CEO pay in the United States found that "CEO compensation is higher when the CEO is also the board chair, the board is larger, there is a greater percentage of the board composed of outside directors, and the outside directors are appointed by the CEO."[22] A more recent study has similarly concluded that board independence is a significant determinant of the

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19 *Compare* Gabaix & Landier, *supra* note 17, at 2 (the "six-fold increase of CEO pay between 1980 and 2003 can be fully attributed to the six-fold increase in market capitalization of large U.S. companies" during that period), *with* Lucian Bebchuk & Yaniv Grinstein, *The Growth of Executive Pay*, 21 OXFORD REV. ECON. POL'Y 283, 286 (2005) (concluding that growth in executive pay between 1993 and 2003 cannot fully be explained by the change in firm size during that period, and suggesting that managerial power may explain the increase in pay).

20 *See* Brian J. Hall & Jeffrey B. Liebman, *Are CEOs Really Paid Like Bureaucrats?*, 113 Q. J. ECON. 653, 671–73 (1998).

21 *See* John E. Core, Wayne R. Guay & Randall S. Thomas, *Is U.S. CEO Compensation Inefficient Pay Without Performance?*, 103 MICH. L. REV. 1142, 1173 & tbl. 2 (2005) (providing evidence that the marginal change in CEO wealth in large U.S. public companies in response to a change in firm value increased by a factor of nearly four between 1993 and 2003).

22 John Core, Robert W. Holthausen & David F. Larcker, *Corporate Governance, Chief Executive Officer Compensation, and Firm Performance*, 51 J. FIN. ECON. 371, 372 (1999).

magnitude of CEO pay.[23] Other work has identified a connection between the strength of the pay-performance link and corporate governance variables. One study, for example, found that equity-based compensation, such as stock options and grants of stock, is used more frequently in firms with outside directors rather than directors appointed by the CEO.[24] Another concluded that the opportunistic timing of stock-option grants in the United States, which undermined the incentive effects of stock options awarded to executives, was more common at firms whose boards were not comprised by majority of independent directors.[25]

To be sure, the empirical literature remains divided on the precise nature of the relationship between governance and executive pay. And, of course, there has been little reconciliation between the two principal schools of thought on the determinants of executive pay at large U.S. public companies. For many commentators, however, a nuanced understanding of the governance features of the firm is necessary to a complete analysis of the optimality of executive pay arrangements from shareholders' point of view. Unfortunately, however, the governance features of Japanese corporations—and their implications for executive compensation—have received relatively little attention.

B. The Institutional Environment for Executive Pay in Japan

As a formal matter, Japanese corporate law charges the board of directors with monitoring corporate activity and making managerial decisions. In practice, however,

23 *See* Vidhi Chhaochharia & Yaniv Grinstein, *CEO Compensation and Board Structure*, 64 J. FIN. 231, 232 (2009). *But see* Katherine Guthrie et al., *CEO Compensation and Board Structure Revisited*, 67 J. FIN. 1149 (2012) (concluding that the relationship between board structure and CEO pay in Chhaochharia & Grinstein, *supra*, was driven principally by outliers).

24 *See* Hamid Mehran, *Executive Compensation Structure, Ownership, and Firm Performance*, 38 J. FIN. ECON. 163, 174 tbl. 3 (1995).

25 Lucian Bebchuk, Yaniv Grinstein & Urs Peyer, *Lucky CEOs and Lucky Directors*, 65 J. FIN. 2363, 2365 (2010).

Japanese boards have not emphasized their monitoring role. This has been particularly true in companies that have retained the traditional Japanese governance structure, in which the board is ostensibly monitored by a group of statutory auditors. More recently, however, Japanese law has permitted boards to adopt a committee structure that charges independent directors with negotiating compensation for top executives.[26]

Previous empirical work has examined executive pay in Japan only indirectly because of the limited disclosure of top managers' compensation. Moreover, no previous empirical work has considered whether governance choices are associated with differences in executive pay. As we explain below, however, a recent change in Japanese law offers the first opportunity for empirical examination of those questions.

1. Japanese Corporate Governance

As we have noted, Japanese boards of directors have traditionally engaged in relatively little monitoring of corporate management or their compensation.[27] In Japan, it has long been commonly understood that a few senior directors enjoy ultimate decision-making authority within the firm, rather than the board as a whole.[28] Indeed, as recently as the late 1990s, the limited influence of the board of directors in Japanese corporate life led a blue ribbon panel to wonder "whether the Japanese board of directors actually complies with the Commercial Code's stipulation that it function[] as the body which decides on corporate will and exercises corporate oversight."[29]

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26 *See* Gilson & Milhaupt, *supra* note 8, at 353 (noting that Japan's 2002 reform allows firms the option to establish committees of the board for audit, nomination, and compensation, which must have at least three members, a majority of whom are outside directors).

27 *See* CORPORATE GOVERNANCE FORUM OF JAPAN, CORPORATE GOVERNANCE PRINCIPLES—A JAPANESE VIEW (FINAL REPORT) 41–42 (1998).

28 *Id.*

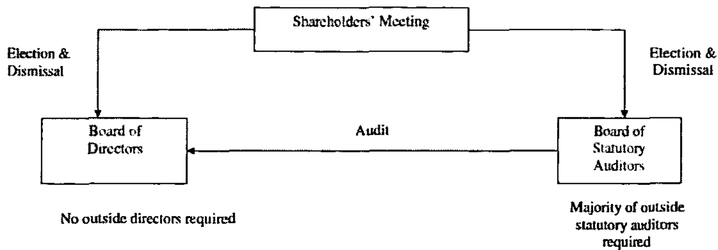
29 *Id.* at 49.

a. Traditional Structure

Influenced by the German supervisory board system, most Japanese firms have an additional body, typically referred to as a board of auditors (*kansayaku*), responsible for overseeing the corporate board. Members of this board are elected by the shareholders. Legally, the board of auditors is charged with monitoring the board of directors' compliance with law.[30] Practically, however, the board of auditors is a fairly weak corporate governance organ,[31] in part as a result of its narrow mandate but also due to its composition: many members of the board of auditors are long-term employees whose service to the firm was meritorious, but not distinctive enough to be rewarded with a seat on the board of directors. The traditional board structure of a Japanese firm (a "company-with-auditors," or *kansayaku secchi kaisha*) is described in Figure 1 below.

FIGURE 1: TRADITIONAL GOVERNANCE STRUCTURE FOR JAPANESE PUBLIC COMPANIES

Option 1: Traditional Governance Structure
- **Statutory Auditor System**



This approach to governance has long shaped the defining characteristics of the corporate board in Japan: deference to managers and a lack of independent directors. Election to the board in Japan has traditionally been viewed almost exclusively as the crowning achievement in a long career

30 *See* Gilson & Milhaupt, *supra* note 7, at 348.

31 *See id.*

with the firm that begins upon graduation from college.[32] Virtually all members of the board have come from the ranks of senior management (typically one from each of the company's major divisions).[33] In fact, until fairly recently, Japanese corporate law did not recognize officers as distinct corporate actors, suggesting that the concepts of director and officer were indistinct. These practices reinforce the common perception that the Japanese board closely identifies with employees. Internal promotion is the norm even today.

Given this traditional view about the role of the board, it is hardly surprising that independent directors have historically played little role in Japanese corporate governance. Outsiders with little firm-specific knowledge are viewed as having little to contribute, and independent judgment does not play a large role in Japanese organizational dynamics.[34] As of 2010, the Tokyo Stock Exchange (TSE) requires that each listed firm have at least one independent director or statutory auditor.[35] As of March 2011, 2,146 TSE listed firms (93.5%) have secured at least one independent director or auditor, but 75.5% of these are independent outside auditors; only 24.5% are independent outside directors.[36] The average number of outside directors per company is 0.91, and only 1.9% of TSE listed companies

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32 *See* Gilson & Milhaupt, *supra* note 7, at 348–49.

33 *See id.* at 348.

34 Compare this to the major stock exchanges in the United States, which now require the boards of listed firms to be comprised of a majority of independent directors. *See* NEW YORK STOCK EXCH., LISTED COMPANY MANUAL § 303A.01 (2013), *available at* http://nysemanual.nyse.com/LCMTools/PlatformViewer.asp?selectednode=chp_1_4&manual=%2Flcm%2Fsections%2Flcm-sections%2F. In addition, the exchanges require that compensation committees of such firms be comprised entirely of independent directors. *See id.* at 303A.00. Tellingly, the legal term used in Japan is "outside" director (*shagai torishimariyaku*), rather than "independent" director. *See* Gilson & Milhaupt, *supra* note 7, at 358.

35 Independence means an "outside [director] who is unlikely to have conflicts of interest with general investors." TOKYO STOCK EXCH., INC., TSE-LISTED COMPANIES WHITE PAPER ON CORPORATE GOVERNANCE 39 (2011) [hereinafter TSE WHITE PAPER].

36 *See id.* at 39–40.

have a majority of outside directors.[37] These recent data suggest a continuing reluctance on the part of most Japanese firms to bring outsiders into the boardroom.

b. Committee Structure

More recently, however, Japanese corporate law has created additional potential roles for non-executive directors. In 2002, a new Company Law codified a menu of board structure options that was enacted in the early 2000s.[38] Japanese companies today have two options in regard to board structure: they may retain the traditional board structure just discussed or, alternatively, they can adopt a committee system modeled after U.S. corporate law and practice (a "company-with-committees," *iinkai secchi kaisha*).[39] Under the committee system, the board must have compensation, nomination, and audit committees. And a company opting for this structure must have a majority of "outside" directors serving on each of the three mandatory committees.[40] Companies-with-committees have U.S.-style corporate officers, and are permitted to delegate corporate decisions to committees of the board. Figure 2 illustrates the committee structure in Japanese firms:

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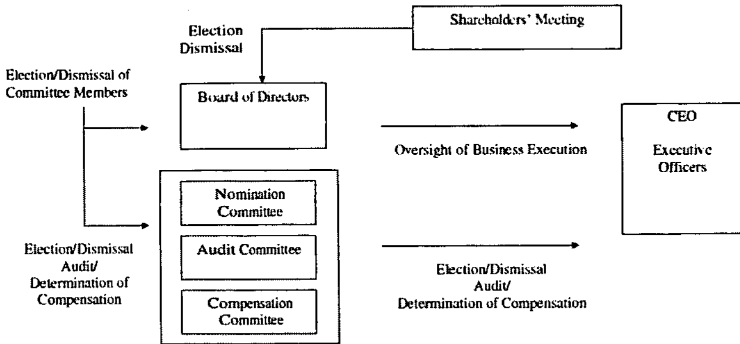
37 *See* TSE WHITE PAPER at 19–20.

38 *See* THE POLITICS OF STRUCTURAL REFORMS: SOCIAL AND INDUSTRIAL POLICY CHANGE IN ITALY AND JAPAN 39 (Hideko Magara & Stefano Sacchi eds., 2013).

39 *Id.*

40 *Id.*

FIGURE 2: COMMITTEE GOVERNANCE STRUCTURE FOR JAPANESE PUBLIC COMPANIES



Overwhelmingly, publicly listed Japanese firms have chosen to retain the traditional auditor system.[41] In total, only 112 publicly traded Japanese firms had adopted the committee system as of April 2009.[42] It is not surprising, then, that relatively little empirical attention has been given to the governance structure of Japanese public companies. And no previous work has provided evidence on the relationship between board structure and executive pay bargains in Japan.

2. Empirical Study of Executive Pay in Japan

Until recently, Japanese law required no disclosure of individual executives' pay, limiting empirical study in this

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41 As of March 2011, 97.8% of all TSE-listed firms are companies-with-auditors; only 2.2% are companies with committees. *See* TSE WHITE PAPER, *supra* note 35, at 15.

42 *See* Robert N. Eberhart, *Corporate Governance Systems and Firm Value: Empirical Evidence from Japan's Natural Experiment*, 6 J. ASIA BUS. STUD. 176, 178 (2012).

area. Previous work indirectly examined Japanese executive pay, for example on the basis of the aggregate pay for the entire board of directors[43] or estimates of compensation drawn from income tax returns.[44] But a recent change in Japanese corporate law now offers the first opportunity to directly measure top executives' pay—and the relationship between executive pay and corporate governance.

In March 2010, Japan's Financial Services Agency (FSA) revised the disclosure requirements for listed companies relating to executive compensation.[45] Prior to the revision, Japanese listed companies were required to disclose, and obtain annual shareholder approval of, the total amount of compensation to be paid to the board of directors as a whole. But no disclosure of individual director-level compensation was required.[46] Today, however, the revised disclosure ordinance requires listed companies to disclose detailed compensation information for each executive whose total compensation for the relevant fiscal year is ¥100 million or more (approximately $1 million, at current exchange rates).[47] The disclosure must describe both the total amount of compensation and the individual components of compensation (salary, bonus, stock options, and "other

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[43] *See* Steven N. Kaplan, *Top Executive Rewards and Firm Performance: A Comparison of Japan and the United States*, 102 J. POL. ECON. 510, 534 (1994).

[44] *See* Minoru Nakazato, J. Mark Ramseyer & Eric B. Rasmusen, *Executive Compensation in Japan: Estimating Levels and Determinants from Tax Records*, 20 J. ECON. & MGMT. STRATEGY 843 (2011); Takao Kato & Mark Rockel, *Experiences, Credentials, and Compensation in the Japanese and U.S. Managerial Labor Markets: Evidence from New Micro Data*, 6 J. JAPANESE & INT'L ECONOMIES 30, 32 (1992).

[45] *See* Daisuke Wakabayashi, *Japan's Executives to Reveal Compensation Under New Rules*, WALL ST. J., June 9, 2010, http://online.wsj.com/news/articles/SB10001424052748703890904575296390830444072.

[46] *See id.*

[47] *Id.*

compensation," which generally consists of retirement pay) for each executive.[48]

The FSA's revision to the compensation disclosure regime was a bolt out of the blue for corporate Japan. Why the sudden change? To be sure, Japanese corporate governance practices have faced a steady stream of criticism over the past decade as a result of the country's economic malaise and protracted stock market slump.[49] Yet few, if any, of these criticisms were directed at executive pay practices at Japanese firms. Although some reformers had concluded as early as 2009 that additional disclosure of executive pay was needed, those proposals did not include mandating that companies reveal individual executives' pay packages.[50]

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48 Wakabayashi, *supra* note 45. For purposes of the ordinance, "board member" includes both executives and "outside" directors, as well as "statutory auditors." *See supra* text accompanying notes 28–33. For ease of exposition, in this Article we will simply refer to the individuals subject to compensation disclosure as "executives."

49 Although compensation practices at Japanese firms have not been the focus of these criticisms, several reports issued by corporate governance organizations in 2008 did recommend disclosures of individual executive pay packages as one of many potential governance reforms. *See* ASIAN CORPORATE GOVERNANCE ASS'N, WHITE PAPER ON CORPORATE GOVERNANCE IN JAPAN 21 (Jamie Allen et al. eds., 2008); PENSION FUND ASS'N, PRINCIPLES OF CORPORATE GOVERNANCE 3 (2010); TOKYO STOCK EXCH., OPINION SUMMARIES RECEIVED FROM INVESTORS IN RESPONSE TO LISTED COMPANY CORPORATE GOVERNANCE QUESTIONNAIRE FOR INVESTOR 21 (2008).

50 Two organizations—the Corporate Governance Study Group, under the auspices of the Ministry of Economy, Trade and Industry, and the Financial System Council's Study Group on the Internationalization of Japanese Financial and Capital Markets under the auspices of the FSA—considered whether executive-compensation reforms were needed in Japan during this period. MINISTRY OF ECON., TRADE AND INDUS., CORPORATE GOVERNANCE STUDY GRP., THE CORPORATE GOVERNANCE STUDY GROUP REPORT 4–5 (2009); FIN. SERVS. AGENCY, REPORT BY THE FINANCIAL SYSTEM COUNCIL'S STUDY GROUP ON THE INTERNATIONALIZATION OF JAPANESE FINANCIAL AND CAPITAL MARKETS 14 (2009). But the final reports of both groups, released in June 2009, recommended only better disclosure of "existing executive remuneration policies" and a breakdown of the types of incentives provided to executives. *Id.* Thus, while compensation-related disclosure was an item on reformers' agendas, as of mid-2009 there was no

Two unexpected catalysts coalesced to change the regulatory dynamic: the global financial crisis and the election of a new government in Japan. First, the financial crisis elevated the political salience of executive compensation worldwide. In Japan, critics focused attention on the gap between the salaries of top managers and average employees, and the large cash reserves maintained by many public companies that, it was asserted, should be used to pay higher salaries to workers. Second, when the Democratic Party of Japan (DPJ) defeated the conservative Liberal Democratic Party (LDP) with the help of labor unions in August 2009, the stage was set for government action. The DPJ, an odd-bedfellows mixture of socialists and breakaway members of the LDP, advanced both pro-labor and anti-bureaucracy policies in its campaign.[51] Since executive compensation in Japan had become linked in the public debate to board practices such as large retained earnings and low dividend payout ratios—salient to both labor unions and investors—it was a politically useful issue for the DPJ.[52]

In February 2010, six months after the change in government, the FSA released its proposed amendment to the disclosure regime for public comment.[53] Not only was the concept of individual director-level disclosure completely unanticipated by the market, the threshold of ¥100 million

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movement in official policy circles to require disclosure of individual pay packages.

51 *See* Hiroko Tabuchi, *Japan's Victors Set to Abandon Market Reform*, N.Y. TIMES, Sept. 1, 2009, at A1.

52 Unlike in the United States, where the level of executive pay and the link between pay and performance have motivated significant recent regulatory change in corporate governance, *see* Robert J. Jackson, Jr., *Private Equity and Executive Compensation*, 60 UCLA L. REV. 638, 665–66 (2013), these considerations did not appear to be among the central motivations for Japanese policymakers in adopting this new regime. As we explain below, *see infra* Part IV.C, for this reason the Japanese disclosure regime does not currently provide investors, regulators or researchers with the data necessary for comprehensive analysis of top executives' pay.

53 Press Release, Fin. Servs. Agency, Proposal of Disclosure Items Concerning Corporate Governance (Feb. 19, 2010), http://www.fsa.go.jp/en/news/2010/20100219-2.html.

specified in the draft ordinance had no independent significance in the Japanese system of executive compensation.

Despite significant criticisms of the process leading to its development—and its substance—the ordinance took effect without significant change in March 2010.[54] Because Japanese firms did not anticipate this development, they lacked adequate time to alter their compensation arrangements in anticipation of the rule change, for example, to shield executives from the new disclosure obligation. Thus, this change in law provides a rare and highly reliable picture of Japanese compensation practices as of early 2010.

III. EVIDENCE ON EXECUTIVE PAY IN JAPAN

In this Part, we present the first detailed, direct evidence on the compensation of Japan's most highly paid executives. First, we provide summary statistics describing the data available from the first year of disclosure under these new rules. We then offer preliminary analysis of this new evidence. While some of our analysis confirms the predictions of previous work, our data present some surprises—and offer a far more nuanced view of the dynamics that determine top executives' pay in Japan than past scholarship has provided.

At a summary level—and consistent with previous work—the data show that Japan's top earners are paid significantly less than the most highly compensated managers in the United States.[55] But a closer look provides preliminary evidence of a previously unexplored relationship between governance and executive pay in Japan. For example, while companies-with-auditors provide most pay in the form of fixed payments like salary, companies-with-committees have adopted a compensation structure far more

[54] *See* Press Release, Fin. Servs. Agency, Disclosure Items Concerning Corporate Governance, (Mar. 26, 2010), http://www.fsa.go.jp/en/news/2010/20100326-1.html.

[55] *See* Kaplan, *supra* note 43, at 536.

familiar in the United States, relying more heavily on performance-based payments like bonuses and stock options. At companies with auditors, firm size is a relatively weak determinant of top executives' total pay. By contrast, at companies with committees, firm size is a far more important predictor of executive pay, consistent with the U.S. literature on executive compensation. Taken together, the preliminary evidence suggests that Japanese firms that have adopted a committee-based board structure have similarly adopted pay practices resembling those at large U.S. public companies.

Although governance choices are associated with significant differences in executive pay in Japan, we find that governance is not the sole determinant of top managers' compensation. Foreign executives, we find, earn substantially more compensation than other managers, although on average they are younger than Japanese executives and have shorter tenure on the board of directors. Moreover, foreigners' compensation relies far more heavily on performance-based payments, like bonuses and stock options, than Japanese executives' pay.

Finally, the evidence shows that Japan's top earners include a substantial number of firm founders. And, while our evidence is generally consistent with previous work concluding that Japanese executives own relatively small amounts of stock in their firms, we find that the founders in our sample own substantial stakes in their companies—pointing to a previously unknown link between pay and performance in Japan.

A. Methodology and Summary Statistics

In June 2010, as required by the FSA's new ordinance, 152 Japanese public companies disclosed that they employed executives who earned in excess of ¥100 million in the previous year. Many of the firms were among Japan's largest public companies; the median market capitalization among the firms subject to the revised ordinance was more than ¥193 billion. Many firms were among Japan's best-known public companies, including Sony, Nissan, Mitsubishi,

Panasonic and Toyota.[56] But the list of firms with disclosing executives also includes far smaller and less well-known firms such as Stella Chemifa and Nac Co.

Together, these 152 firms disclosed detailed information on the compensation of the 269 Japanese executives who earned more than ¥100 million in the previous year. We constructed a hand-drawn dataset including information on salary, bonus, stock options, retirement benefits, and other compensation paid to each individual, as well as the stock ownership and tenure of each individual executive.[57] Using biographical information included in the *Yuka Shoken Hokokushko*—the Japanese equivalent of the Form 10-K in the United States—we also collected data indicating whether the executive was a founder of the company or a non-Japanese serving as an executive at a Japanese firm.[58] Table 1 below provides summary information on the compensation and characteristics of the executives subject to Japan's new compensation disclosure regime in 2010.

56 A compendium of the firms required to disclose executives' compensation in 2010 is included in the Appendix. *See infra* Table 1.

57 We are grateful to Oakaya Seki of Corporate Practice Partners, Inc., and Yoshiko Habe, of the Columbia Law School LL.M. class of 2011, for their assistance in constructing this dataset.

58 On the basis of our review of the *Yuka Shoken Hokokushko*, we identified founders as managers who participated in the founding of the firm, whether or not the executive continues to retain substantial ownership. We separately identified foreign executives as those without Japanese family names whose prior experience consisted principally of employment in countries other than Japan. Coding these distinctions was generally straightforward on the basis of the information included in the *Yuka Shoken Hokokushko*.

TABLE 1: SUMMARY STATISTICS: INDIVIDUAL EXECUTIVES

Median Age	64
Median Tenure (years)[59]	16
Median Salary	¥93,000,000
Median Bonus	¥27,000,000
Medan Total Compensation	¥135,000,000
Median Executive Stock Ownership	0.02%
Median Firm Market Capitalization	¥193,000,000,000

At a summary level, our evidence on the compensation of individual executives in Japan is generally consistent with previous work on Japanese managers' pay. For example, with respect to total pay levels, the data are consistent with prior work indicating that top Japanese executives earn considerably less total compensation and own smaller proportions of their firms' stock than their U.S. counterparts.[60] The median executive among Japan's 269 most highly paid managers earned ¥135 million in total compensation in 2010 (approximately $1.48 million at the then-prevailing exchange rate). By contrast, among the 269 most highly paid executives in the United States in 2010, the median manager's total compensation was approximately ten times greater, at about $16.7 million.[61]

59 Throughout this Article, we use the term "tenure" to refer to the number of years between the date on which the executive took his or her seat on the company's board of directors or board of statutory auditors and the end of 2010.

60 *See* Kato & Rockel, *supra* note 44, at 33.

61 This figure was calculated by drawing annualized compensation data for all U.S. executives whose compensation was required to be disclosed in 2010, ranking the managers by total compensation disclosed pursuant to U.S. disclosure rules, *see* 17 C.F.R. § 229.402 (2013), and calculating the median compensation for the 269 highest-paid managers by that measure. *See* COMPUSTAT, EXECUCOMP ANNUAL COMPENSATION DATASET, http://wrds-web.wharton.upenn.edu (last accessed Sept. 17, 2012); *see also* WRDS FAQS, http://wrds-web.wharton.upenn.edu/

This is not to say that all executives at Japanese firms receive relatively low levels of pay. Japan's top earner that year, Carlos Ghosn of Nissan, earned ¥891 million, or about $9.8 million, in 2010. The next most highly paid executive, Howard Stringer of Sony Corporation, earned ¥814 million, or approximately $8.9 million. Nor were high amounts of total compensation limited to foreigners: Japan's third highest-paid executive, Yoshitoshi Kitajima of Dai Nippon Printing Co., earned ¥787 million, or about $8.6 million.

Moreover, for many firms, the disclosures were not limited to a single highly paid executive. Several of Japan's most well-known corporations were required to disclose compensation details for more than one executive. Table 2 below describes the public companies required to disclose compensation for the largest number of individuals during the first year that Japan's revised ordinance was in effect:

wrds/about/WRDS%20FAQs.cfm (last visited Mar. 5, 2014). Our finding that average pay is statistically significantly higher for the U.S. executives than for their Japanese counterparts is robust to controls for executives' incentives, including their stock ownership, as well as controls for firm size and Tobin's Q.

TABLE 2: SUMMARY STATISTICS: FIRMS DISCLOSING COMPENSATION FOR MULTIPLE EXECUTIVES

	Number of Firms	Average Executive's Total Compensation
Seven Executives Earning More Than ¥100M	3 (Nomura Corporation, Sony Corporation, and Nissan Motor Co.)	¥241 million
Six Executives Earning More Than ¥100M	4 (Mizuho Financial, Daiwa Securities, Nintendo Co., and Fanuc)	¥136 million
Five Executives Earning More Than ¥100M	3 (Mitsubishi, Nippon Sheet Glass, and Softbank Corporation.)	¥145 million
Four Executives Earning More Than ¥100M	3 (Dai Nippon Printing Co., Toyota, and Shinsei Bank)	¥177 million

But summary data like these, however intriguing, only scratch the surface of the detail offered by Japan's new disclosure regime. Because the revised ordinance also requires disclosure of the elements of each executive's pay, we can evaluate for the first time the structure of Japanese executives' compensation. Combining these disclosures with detail on governance structure, we can also consider the relationship between executive pay and corporate governance in Japan.

B. Corporate Governance and Executive Pay

Previous work has explored whether corporate governance in Japan is an important explanatory factor with respect to firm value.[62] In this section, we assess whether the structure and amount of executive pay in Japan is associated with a Japanese firm's choice between the statutory-auditor or committee-style board structure.

As we have noted, a common theme in the U.S. literature on executive pay is that compensation committees comprised of independent directors are likely to drive a harder bargain with top executives, resulting in pay arrangements more closely aligned with shareholder interests.[63] Do Japanese boards that have chosen the committee structure—and, thus, have "independent" compensation committees comprised mostly of outside directors—obtain a different bargain over executive pay than traditional Japanese boards?

Among the 152 firms required to disclose individual executives' pay in 2010, 141, or 93%, retained the traditional auditor structure, while just 11, or 7%, had adopted committees. Table 3 below summarizes the characteristics of each group of firms:

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[62] *See* Eberhart, *supra* note 42; *see also* Gilson & Milhaupt, *supra* note 7, at 343.

[63] *See* Chhaochharia & Grinstein, *supra* note 23, at 232.

TABLE 3: FIRM CHARACTERISTICS BY GOVERNANCE STRUCTURE[64]

	Firms with Auditors (N = 141)	Firms with Committees (N = 11)
Average Percentage of Sales from Outside Japan	35.0%	45.0%**
Average Percentage of Shares Owned by Japanese Corporations and Banks	35.0%	27.8%***
Average Percentage of Shares Owned by Foreign Investors	24.8%	40.0%***
Average Fraction of Firms with Foreigners on the Board	5.7%	63.6%***
Average Number of Outside Directors	1.2	5.9***
Average Tobin's Q	1.15	0.9
Average Market Capitalization	¥1.3 billion	¥1.5 billion

As Table 3 shows, the firms in our sample that have selected the committee structure generally depend more on international markets for revenues, investors, and directors than the firms that have retained the statutory-auditor

64 Throughout this Part, we use the standard identifiers of statistical significance for differences among means: "***" indicates significance at 99% confidence, "**" indicates significance at 95% confidence, and "*" indicates significance at 90% confidence. In Tables III and IV, these identifiers refer to the correlation coefficient for a dummy variable indicating whether the firm has a committee or statutory auditor structure in a regression also controlling for the firm's industry and firm value as measured by Tobin's Q, or the ratio of the firm's market value to the book value of its assets. Tobin's Q is a commonly used measure for determining the effectiveness with which corporate management convert assets into equity value. *See* James Tobin, *A General Equilibrium Approach to Monetary Theory*, 1 J. MONEY, CREDIT & BANKING 15 (1969).

structure. Indeed, the committee firms include some of Japan's most recognizable brands, such as Toshiba, Sony and Nomura. A much larger fraction of these firms also feature foreign directors, and unsurprisingly the firms also have more independent directors. But the two groups include firms that are generally of comparable value, as measured by Tobin's Q, and size, as measured by market capitalization.

How do the executives subject to the new disclosure regime at firms with committees compare with executives at more traditionally governed Japanese companies? Table 4 below summarizes the characteristics of the executives in our dataset at each type of firm:

TABLE 4: EXECUTIVE CHARACTERISTICS BY GOVERNANCE STRUCTURE

	Executives at Firms with Auditors (N=234)	Executives at Firms with Committees (N = 35)
Average Age	63.6	58.8***
Average Tenure on the Board of Directors	21.2	10.9***
Average Total Compensation	¥165 million	¥173 million

As Table 4 shows, the characteristics of the executives at firms with statutory auditors differ significantly from the executives at firms with committees. Executives at companies that have retained the statutory-auditor structure are statistically significantly older than their counterparts at firms with committees, and on average they have served on the corporate board for twice as long. Despite these differences, however, the magnitude of compensation is statistically similar for executives at the two groups of firms.

1. Compensation Structure

Japan's new disclosure regime permits us to evaluate not only the magnitude of compensation but also its structure. Table 5 below summarizes the average percentage of total compensation attributable to each element of pay for executives at firms with committees and firms with auditors, respectively:

TABLE 5: COMPENSATION STRUCTURES FOR HIGHLY PAID EXECUTIVES AT JAPANESE FIRMS, BY GOVERNANCE TYPE[65]

	Salary	Bonus	Stock Options	Retirement Benefits	Other Comp.
Executives at Firms with Committees (N = 35)	52%**	31%***	9%*	2%	1%
Executives at Firms with Auditors (N = 234)	62%	13%	6%	7%	1%

Table 5 suggests that compensation structures for executives at firms with committees are more closely tied to performance than pay for executives at firms with statutory auditors.[66] On average, the highest-paid executives at firms

65 In Table 5, indicators of significance refer to simple t-tests for differences between means.

66 Coding with respect to whether a particular firm uses a statutory-auditor or committee structure was based on the governance structure described in each firm's disclosures. Further research, however, revealed that two firms that described themselves as statutory-auditor firms, Shinsei Bank Ltd. and Columbia Music Entertainment, changed from the committee to statutory-auditor structure just before they were required to disclose their governance arrangements. Because compensation structures, which must be determined well in advance of these disclosures,

with committees receive some forty percent of their compensation in performance-sensitive payments such as bonuses and stock options.[67] By contrast, top managers at firms with statutory auditors receive less than twenty percent of their compensation in those forms.[68]

Of course, as we have noted, these differences in compensation structure may be attributable to the other differences we have described between the groups of statutory-auditor and committee firms. In particular, these differences could be related to the significantly greater incidence of non-Japanese executives in firms that have adopted the committee structure than in traditional statutory-auditor firms, or alternatively the significantly greater incidence of founding executives in firms that have retained the statutory-auditor structure. Thus, we recalculated the results in Table 5 in separate analyses that

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were likely set by committees rather than statutory auditors, we recoded our dataset to characterize these firms as committee firms rather than statutory-auditor firms. Our results were unchanged, and indeed the regression models described in the Appendix yielded correlation coefficients between governance structures and compensation structures of greater economic and statistical significance. We generally report our results based on the two firms' disclosed governance structures, but changing their coding in this way would not meaningfully affect our results.

67 While previous work on executive compensation in the United States has suggested that bonuses do not succeed in linking pay to performance, *see* Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 J. POL. ECON. 225, 251 (1990), we include bonuses in the calculation of performance-sensitive pay for Japanese managers because firms' disclosures suggest that these bonuses depend significantly on performance measures.

68 Executives at firms with statutory auditors and those at companies with committees appear to receive similar fractions of their pay in the form of "other" compensation such as perquisites; on average, Japan's highest-paid executives receive only about one percent of their pay in this form. Perquisites therefore appear to reflect a smaller proportion of top executives' pay in Japan than in the United States and Europe. *See, e.g.*, SUBODH MISHRA, ISS CORPORATE SERVS., STOCKING UP: POST-CRISIS TRENDS IN U.S. EXECUTIVE PAY 2 (2012) (reporting that perquisites represent, on average, approximately eighteen percent of total compensation in the United States).

exclude, in turn, non-Japanese executives and founders from the dataset. Our results were unchanged.[69]

Moreover, executives at firms that retained the statutory-auditor structure have significantly longer tenure than their counterparts at companies with committees. This finding is consistent with prior work arguing that traditionally Japanese executives receive more certain compensation over long tenure with the firm—in contrast to American executives, who, as victors of the internal talent tournament in a firm owned by dispersed shareholders, receive larger pay packages designed to align compensation with performance, but generally enjoy shorter tenure.[70] Our evidence is consistent with that literature. The executives in our sample who have served on the board longer than the sample's median tenure of sixteen years receive, on average, fourteen percent of their pay in the form of performance-based compensation such as stock options and bonuses. By contrast, executives with less than the median tenure receive twenty-nine percent of their compensation in performance pay.

In light of these important executive-level differences, in the Appendix we subject the trend in Table 5 to regression analysis controlling for, among other things, differences in firm characteristics such as size, industry, and firm value, as well as executive-specific differences, including variables

69 The differences between pay structures for executives at firms with statutory auditors and those at firms with committees described in Table 5 are virtually unchanged when the data are adjusted to remove foreigners. Excluding foreigners, executives at firms with auditors received on average 63% of their compensation in salary, 13% in bonuses, and 6% in stock options, while executives at firms with committees received 54% of their compensation in salary, 30% in bonuses, and 9% in stock options. Similarly, the results are not changed when founders are excluded. Excluding founders, executives at firms with auditors received on average 60% of their compensation in salary, 15% in bonuses, and 8% in stock options, while executives at firms with committees received 53% of their compensation in salary, 27% in bonuses, and 9% in stock options.

70 *See* Randall S. Thomas, *Explaining the International CEO Pay Gap: Board Capture or Market Driven?*, 57 VAND. L. REV. 1171, 1211–16 (2004).

indicating whether the executive is a foreigner or founder along with controls for age and tenure. Both tests confirm that the percentage of compensation attributable to performance-based pay is statistically significantly greater for executives at companies with committees.

2. Compensation and Firm Size

Previous work has found that the average director's compensation in Japan increases with firm size, a conclusion consistent with the finding in the broader literature that higher levels of executive pay are associated with increased firm size.[71] Our data, too, show that the average director's compensation increases with firm size. But our individual-level data on executive pay in Japan suggest that firms' governance choices provide critical context for assessing the relationship between firm size and compensation levels. Table 6 below summarizes the compensation levels of Japan's most highly paid executives according to firm size and the firms' governance structures:

TABLE 6: AVERAGE TOTAL COMPENSATION OF HIGHEST-PAID JAPANESE EXECUTIVES, BY FIRM SIZE

	Bottom Three Quartiles of Firm Size	Top Quartile of Firm Size
Average Total Executive Pay at Firms with Committees (N = 35)	¥140 million	¥198 million**
Average Total Executive Pay at Firms with Statutory Auditors (N = 234)	¥171 million	¥156 million

[71] *See, e.g.*, Kaplan, *supra* note 43, at 540 (finding that the average Japanese director's compensation rises with firm size); Bebchuk & Grinstein, *supra* note 19, at 284 (describing the extensive literature establishing the relationship between pay levels and firm size).

As Table 6 shows, among Japan's top executives, the relationship between total pay levels and firm size depends, in part, on the firm's governance structure.[72] Among firms with the traditional statutory auditor structure, firm size has relatively little predictive power with respect to pay levels. By contrast, among firms with committee structures, firm size is strongly correlated with the magnitude of top executives' compensation—a result consistent with the literature on executive pay in the United States.

3. Pay Equity Inside the Japanese Boardroom

The first examination of the compensation of individual Japanese executives also allows us to compare differences between top executives' pay and the compensation received by the average director at that executive's firm. As we have previously noted, the median executive in our sample earned ¥135 million during the fiscal year ending in 2010. By comparison, the average director at the median firm in our sample earned ¥47 million. The median gap between the disclosed pay for top executives and the average director at that executive's firm is ¥91 million. At least for firms

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[72] In Table 6, indicators of statistical significance refer to the correlation coefficient for firm size in a regression also controlling for industry and firm value (as measured by Tobin's Q). We present in Table 6 the results for all 269 executives in our sample, which includes more than one executive at several firms, *see supra* text accompanying note 61 & tbl. 2. When we limit our analysis only to the highest-paid individual at each firm, as in previous work, *see* Nakazato et al., *supra* note 44, at 865, 869 tbl. V, we find a positive and statistically significant (at the 95% confidence level) relationship between firm size and total compensation, both at firms with committees and firms with statutory auditors. The magnitude of the firm-size effect, however, is far more economically significant for companies with committees; in those firms, the top executive at the largest quartile of firms on average earns more than three times the top executives at smaller firms, while at companies with statutory auditors the average top executive at the largest quartile of firms earns approximately 38% more than the top executive at smaller firms. Moreover, in unreported analysis we find that the correlation coefficient for firm size is statistically significantly larger for companies with committees than at companies with statutory auditors.

required to disclose the compensation of their most highly paid executive(s), the top earner(s) appear to earn far more—approximately three times as much—as their colleagues in the boardroom.

A closer look at the data, however, reveals an important interaction between the gap between executive and director pay, firm size, and Japanese corporate governance. For firms that have retained the statutory-auditor structure, the compensation gap between top executives and their director colleagues narrows as firm size increases. By contrast, for companies-with-committees, this gap grows quite substantially as firm size increases. Table 7 below summarizes the gap between compensation for the highest-paid executives and average directors in Japan, conditional on firm size and governance structure:

TABLE 7: DIFFERENCES IN COMPENSATION BETWEEN JAPANESE EXECUTIVES AND DIRECTORS[73]

	Bottom Three Quartiles of Firm Size	Top Quartile of Firm Size
Average Executive-Director Pay Gap, Firms with Committees (N = 35)	¥116 million	¥155 million***
Average Executive-Director Pay Gap, Firms with Statutory Auditors (N = 234)	¥120 million	¥80 million

73 In Table 7, indicators of significance refer to the correlation coefficient for firm size in a regression in which the independent variable is the gap between the disclosed executive's compensation and the average compensation of a director at that executive's firm, controlling for industry, firm value (as measured by Tobin's Q), and whether the individual executive is a foreigner or founder.

For firms with statutory auditors, Table 7 confirms our previous finding that firm size is a relatively unimportant determinant of top executives' pay—even though, consistent with the previous literature, the average director's compensation increases along with the size of the firm. For firms with committees, however, firm size is an important determinant of top executives' compensation—and, thus, as firm size rises, so does the gap between the compensation of top executives and that of the average director. This result does not appear to be associated strictly with particular executive characteristics. When we subject the results in Table 7 to multivariate analysis, we find that the results are robust to additional executive-level controls—for example, for whether the executive is a foreigner or founder[74]—and that more extensive regression analysis confirms the findings in Table 7.[75]

Taken together, the evidence suggests an important relationship between Japanese firms' governance structure and executive compensation. Firms that have adopted the committee structure, which are more exposed to international markets and more likely to feature foreigners in the boardroom, have adopted practices consistent with the literature on executive pay in the United States. These firms pay much larger proportions of compensation in

74 Among the thirty-five executives at firms with committees, seven were foreigners and two were founders. Controlling for these executive-level characteristics did not change the results described in Table 7. Indeed, although multivariate models without these controls revealed a statistically significant relationship between firm size and the executive-director pay gap among companies with committees, the economic and statistical significance of that finding was strengthened when controlling for individual executives' status as foreigners or founders.

75 In the Appendix, we further explore the relationship identified in Table 7 by examining whether an interaction term between firm size and corporate governance is a statistically meaningfully determinant of the gap between top executives' pay and the average director's compensation. We find, consistent with Table 7, that a dummy variable indicating that the firm features the company-with-committees structure is statistically and economically significantly related to the relationship between firm size and pay equity in the Japanese boardroom. *See infra* Table II.

bonuses and stock options—and pay more total compensation to executives at the helm of larger firms in comparison to other managers.

By contrast, firms that have retained the traditional statutory-auditor structure appear to compensate top managers in strikingly different fashion, relying on long board tenure rather than performance-based compensation to reward executives. And, at these firms, the total level of compensation appears to be subject to an informal upper bound that directors carefully observe. Thus, even as increases in firm size justify higher pay for other members of the board, top executives whose compensation is already approaching this upper limit do not receive further increases in pay.

C. Foreign Executives

Twenty-one executives, or about eight percent of the managers in our sample, are non-Japanese serving as executives at a Japanese public company. Because a foreign executive's compensation may be influenced by pay practices outside Japan, we separately evaluated the characteristics and compensation of the foreign executives in our sample. Table 8 below provides summary statistics describing the foreign executives whose compensation was disclosed under the new ordinance in 2010:

TABLE 8: SUMMARY CHARACTERISTICS: FOREIGN EXECUTIVES

	Non-Japanese Executives	Japanese Executives
Median Age	53	64
Median Tenure	6	17
Median Firm Market Capitalization	¥832 billion	¥623 billion

As Table 8 shows, the foreign executives among Japan's top earners are younger than their Japanese counterparts, have served on the company's board for shorter periods of

time, and generally run larger companies. How does the compensation of foreign executives differ from that of Japanese managers? Table 9 compares the total compensation of foreign executives to that of their Japanese counterparts:

TABLE 9: FOREIGN EXECUTIVES' TOTAL COMPENSATION[76]

	Non-Japanese Executives	Japanese Executives
Average Total Compensation	¥230 million***	¥161 million
Percentage of Compensation Paid in Stock Options	9.4%***	6.0%

Table 9 gives striking evidence of the relationship between an executive's nationality and his compensation. Among Japan's most highly paid executives, non-Japanese earn over forty percent more than Japanese managers. Moreover, foreigners receive a statistically and economically significantly greater proportion of their pay in the form of stock options. We subjected these results to multivariate regression analysis controlling for the firm's governance structure, along with variations in firm size and industry as well as the executives' age and tenure.[77] The results in Table

76 In Table 9, indicators of statistical significance refer to the correlation coefficient for a dummy variable indicating whether the executive is a foreigner in a regression also controlling for age, tenure, governance structure, and firm size, expressed as the log of the firm's market capitalization.

77 This analysis allows us to address the possibility that the higher pay we find for non-Japanese managers is related to the managers' status as newly hired executives rather than their non-Japanese status. On average, the non-Japanese executives in our dataset have served on their company's board of directors for more than eleven years, so it is unlikely that the timing of their hiring influences their pay level. Moreover, the multivariate regression models described in the Appendix control for each

9 were robust to those tests. Foreign executives at Japanese firms earn far more—and receive much larger proportions of their pay in the form of stock options—than their Japanese counterparts.

D. Founding Executives

We identified seventy-seven executives, or about twenty-nine percent of the managers in our sample, as founders. The overwhelming majority of these founder-executives sit on boards of directors that have retained the traditional statutory-auditor governance structure. Table 10 below summarizes the distribution of founders among the 152 firms in our sample:

TABLE 10: FIRM CHARACTERISTICS BY FOUNDER STATUS

	Firms with Auditors (N=141)	Firms with Committees (N=11)
Number of Firms With Founders (Percentage of Firms)	75 (46%)	2 (18%)

Among the seventy-seven founders in our sample, seventy-five are at firms with statutory auditors; indeed, only two founders in our sample are at firms that have elected to adopt the committee structure.[78] Plausibly, founders overwhelmingly avoid the committee structure because it is perceived to entail dilution of the founder's control (since at least two independent directors are needed to serve on the required committees). Since founders are so prominent in our sample—and are unevenly distributed

executive's tenure, and the results described in Table 9 are robust to those controls—indicating that a manager's status as a foreigner has an independent relationship with the level of her pay. We are grateful to Mariana Pargendler for suggesting this analysis.

[78] These executives are Haruo Naito of Eisai and Hiroshi Suzuki of Hoya Corporation.

between firms that retained the statutory-auditor structure and those that adopted committees—we performed the analysis described earlier in this Part while controlling for founders or simply excluding all founders from our sample. The results were unchanged.[79]

Because the literature on executive pay suggests that founders' influence over the board and their firms more generally may lead to differences in their compensation,[80] we separately explored potential differences in the compensation and incentives of the founding executives subject to Japan's new disclosure regime. Table 11 below summarizes the characteristics of the founders in our sample:

TABLE 11: SUMMARY CHARACTERISTICS: FOUNDING EXECUTIVES

	Founding Executives	Non-Founders
Median Age	62	64
Median Tenure	29	12***

As Table 11 shows, although the founding executives in our sample are slightly younger than non-founders, they

79 Outside the Japanese context, prior literature has argued that there are significant differences in governance and compensation at founder firms. *See* John C. Coates IV & Reinier Kraakman, *CEO Tenure, Performance and Turnover in S&P 500 Companies* (Harvard Law Sch. John M. Olin Center for Law, Econ. & Bus. Discussion Paper Series No. 595, 2007) *available at* http://lsr.nellco.org/cgi/viewcontent.cgi?article=1383&context=harvard_olin. Thus, we ran the analysis described in this Part while including controls for a dummy variable identifying individuals as founders and also while excluding these individuals altogether. Our results were unchanged.

80 *See, e.g.*, NOAM WASSERMAN, EXECUTIVE COMPENSATION IN ENTREPRENEURIAL TEAMS: THE FOUNDER GAP, BOARD MEMBERSHIP, & PAY FOR MILESTONES (2004), *available at* http://www.people.hbs.edu/nwasserman/entrepcomp_proceedings.pdf (finding that founders receive less total pay, perhaps because their firm-specific human capital makes them less attractive to alternative employers).

have significantly longer tenure on the board of directors. The median founder in our sample has served nearly thirty years on the board of his firm.

Table 12 summarizes the average total compensation of the founders and non-founders in our sample:

TABLE 12: FOUNDING EXECUTIVES' TOTAL COMPENSATION

	Founding Executives	Non-Founders
Average Total Compensation	¥176 million	¥160 million

Although on average founders receive slightly higher levels of total pay than the non-founders among Japan's most highly paid managers, total compensation between the two groups of executives is statistically indistinguishable.[81] It does not appear that founders still serving as Japanese executives receive different levels of pay from their non-founder counterparts.

As we have previously noted, our findings, consistent with previous empirical study of managerial stock ownership in Japanese firms, suggest that Japan's top executives own relatively little stock in their companies. Founders, however, may have significant stakes in their firms. Do the founding executives of Japanese companies, unlike non-founder counterparts, own substantial holdings of stock in their companies? Table 13 below summarizes the stock ownership of the executives included in our sample:

81 The means for total compensation for founders and non-founders are not statistically significantly different, and when we subjected that result to more extensive multivariate regressions, a dummy variable indicating whether the executive was a founder generally did not have a statistically significant correlation coefficient.

TABLE 13: MANAGERIAL STOCK OWNERSHIP AMONG JAPAN'S HIGHLY PAID EXECUTIVES

	Founding Executives	Non-Founders
Average Percentage of Stock Ownership	10.4%***	0.6%

As Table 13 shows, although founding executives receive similar levels of pay to their non-founder counterparts, the founders among Japan's mostly highly compensated managers retain significant equity stakes in their companies after the firm is taken public. Within the pool of disclosing executives, founders own more than ten times as much stock in the firm as non-founders. We subjected this result to multivariate regression analysis controlling for differences in firm size, industry, and the executive's age, tenure, and total compensation. The results in Table 13 were robust to those tests. The founders among Japan's most highly paid managers hold substantially greater stakes in their firms than their non-founder counterparts.

Because the compensation literature has long argued that the relationship between pay and performance is established through executive stock ownership,[82] founding executives' substantial stock holdings—and these executives' prominence among Japan's most highly-paid corporate employees—indicates that a substantial fraction of top executives in Japan are subject to an unusually strong link between pay and performance. Although the finding that a substantial proportion of the firms in the economy are founder firms, and that these founders retain substantial stock ownership, is not unique to Japan,[83] the evidence on

82 *See* Core et al., *supra* note 21, at 1144.

83 *See* Ronald C. Anderson & David M. Reeb, *Founding-Family Ownership and Firm Performance: Evidence from the S&P 500*, 58 J. FIN. 1301, 1302 (2003) (finding that in the United States, family firms constitute over thirty-five percent of the S&P 500 and own, on average, nearly eighteen percent of their firms' outstanding equity).

Japanese founders' ownership offers new perspectives on the relationship between pay and performance in the modern Japanese firm.[84]

IV. IMPLICATIONS AND QUESTIONS FOR FUTURE RESEARCH

The first direct evidence on how Japan's most highly compensated managers are paid reveals striking new detail on the relationship between corporate governance and executive pay. In this Part, we describe three implications of these findings for the study and regulation of executive pay around the world. First, we explain that lawmakers should be conscious of the potential interaction between governance structures and executive compensation arrangements. Second, we provide a framework for additional research that may shed further light on the relationship between corporate governance and executive pay identified here. Finally, we propose several changes to Japan's new executive pay disclosure rules that would allow researchers and investors to draw more meaningful conclusions from the information that Japanese companies provide.

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[84] Because, on average, founding executives own more than ten percent of their companies' stock, it might be argued that the founders essentially enjoy a control stake, enabling them to exercise control over governance choices, including the level and structure of executive pay. While our data offer some evidence in support of that possibility, *see supra* text accompanying notes 78–79 (noting that very few firms with founders have selected the committee-governance structure), other preliminary tests of that hypothesis were inconclusive. For example, we considered whether firms with founders would feature lower total pay, or more performance-sensitive pay, for top executives other than the founder, reflecting the founder's ability to exercise control over his colleagues' compensation. We did not, however, find statistically significant differences between the total compensation, or compensation structures, of non-founding executives at firms where founders continue to serve on the board.

A. Institutional Complementarities of Pay and Governance

Lawmakers around the world have, over time, gravitated toward legal intervention on matters of executive compensation.[85] The general forms such interventions have taken—largely centered on outside-director oversight of the pay-setting process and mandatory disclosure—are fairly similar. Yet these legal interventions take place against vastly different pre-existing institutional landscapes, and those institutional differences may have significant implications for the effects of those interventions. This Article has identified a new area—the relationship between board structure and pay—in which institutional complementarities appear to play a critical role.

Although Japanese regulators have borrowed heavily from U.S. corporate law over the past two decades, the pay-governance link in Japan is still deeply rooted in distinctive national institutions. The theoretical and empirical literature on executive compensation, focused heavily on the United States, must be understood against the backdrop of the distinctive U.S. institutional context from which it emerged. Regulators worldwide have borrowed from a relatively small tool kit in addressing compensation issues, but the nature of the issues they seek to address, and the setting for the pay-governance relationship, differ vastly from country to country.

Thus, to fully evaluate Japan's current approach to regulation of executive compensation, we must ask a prior question: would a move toward more performance-based pay be good for Japanese corporate governance? If one takes the complementary set of U.S. corporate governance institutions as a given, the answer is quite clearly yes.[86] But as we have shown, the institutional setting for executive pay in Japan is

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85 *See* JOHNSON & BENNETT, *supra* note 2, at 4.

86 *See supra* text accompanying notes 9–13 (describing literature arguing that because agency costs may lead to managerial slack at U.S. public companies, performance-based compensation may induce managers to exert more effort).

very different from that in the United States.[87] Thus, it may be wrong to assume that more performance-based pay would necessarily lead to improved corporate performance in Japan.

Moreover, given the two quite different sets of board structures in Japan, there may not be a single answer to this question for all Japanese firms. At present, our evidence shows, the use of performance-based pay in Japan is largely limited to companies with committees. If managers at companies with committees are most in need of financial motivation, this may well be a desirable outcome for investors. But what if traditional auditor-style firms would benefit more from enhanced incentives for management, perhaps because those firms lack the outside directors or foreign institutional investors who might provide impetus for greater managerial effort? On the other hand, widespread adoption of performance-based pay practices may have unintended consequences for Japanese corporate governance. For example, without the concomitant adoption of complementary institutions—such as a relatively robust external auditing system and an active environment for private securities litigation—could more performance-based pay lead to increased and new types of corporate fraud in Japan?[88]

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87 *See supra* Part II.B.

88 Indeed, it is far from clear why the few Japanese executives who are already accountable to outside directors are more in need of performance-sensitive pay than those overseen by more traditional Japanese boardrooms. To the contrary, independent oversight and performance-sensitive pay might be better theorized as substitutes. If so, it may not be desirable for firms to simultaneously adopt the committee structure and performance-sensitive pay. It is well-known that outside directors lack the familiarity with corporate operations that insiders typically enjoy, *see* Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1470 (2007), and it may therefore be more difficult for these directors to detect fraud. But performance-sensitive pay arrangements may encourage executives to engage in such conduct. *See, e.g.*, Lynn Bai, James D. Cox & Randall Thomas, *Lying and Getting Caught: An Empirical Study of the Effect of Securities Class Action Settlements on Targeted Firms*, 158 U. PA. L. REV. 1877, 1882 (2010)

The preliminary evidence presented in this Article cannot, of course, fully answer these questions. By revealing the link between governance and pay structures in Japan, however, this Article has identified an important new relationship between the design of governance institutions and the incentives that top managers face in Japanese corporations. Lawmakers and investors throughout the world, therefore, should take careful account of the relationship between governance and executive pay when considering new interventions on either front. And, as we explain below, researchers should further explore the questions of institutional complementarity identified here.

B. Future Research on Governance and Executive Pay

The new insights made possible by Japan's recent compensation disclosure reform raise fundamental questions about the determinants of executive pay in Japanese companies. In this section, we highlight the most pressing issues for future research.

1. Pay Levels

The comparatively low level of executive compensation in Japan, regardless of governance structure, is one of the most striking facts highlighted by our data.[89] From the perspective of economic theory, this is very puzzling. We have noted that Japanese boards have few independent directors, and domestic institutional investors tend to be passive. The agency model of executive compensation

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(noting that, in the United States, "compensation based on firm value is associated with abnormal accounting accruals and even fraud as executives try to make sure they" profit from these pay arrangements). Thus, it cannot be assumed that widespread adoption of performance-based pay in the Japanese managerial system, without other institutional reforms, would necessarily be desirable for investors.

89 *See supra* text accompanying note 61 (noting that the median pay of Japan's 269 highest-paid managers was approximately one-tenth of the median pay of the United States' 269 highest-paid managers in 2010); *see also* Kaplan, *supra* note 43, at 534 (describing a similar analysis comparing managerial pay in Japan to pay practices in the United States).

dominant in the U.S. literature suggests that this would be an ideal environment for managerial wealth extraction from shareholders.[90] Why don't Japanese executives pay themselves more?

While our data do not allow us to answer this question definitively, several potential explanations are consistent with the individual-level compensation disclosures we have examined. Significantly, whatever constraints limit Japanese executive pay appear to be common to all Japanese managers, regardless of whether they lead a firm with the traditional auditor system or the new committee system. One possibility is that the "outrage constraint" on executive pay is triggered at a lower level of compensation in Japan than elsewhere as a result of widely held norms about social equality, possibly buttressed by the comparatively high degree of ethnic homogeneity in Japan.[91]

The new individual-level disclosures now provided under Japanese law should permit future researchers to evaluate this hypothesis. In particular, future work should test whether Japanese shareholders—making use of Japan's say-on-pay system—enforce compliance with these norms by expressing reservations about large pay packages. Separately, researchers should consider whether the existence of the disclosure regime itself is likely to influence pay practices in Japan. Will learning about how much their peers earn lead Japanese managers to seek equivalent or higher levels of pay from their boards? Or will the disclosure regime limit pay, leading firms to adjust their pay practices to minimize the number of disclosing executives by clustering compensation packages just below the disclosure threshold? Future research taking advantage of more years of pay disclosures will shed light on the impact of Japan's disclosure regime on compensation practices. These insights,

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[90] *See supra* text accompanying notes 9–12 (describing the literature on executive compensation in the United States that advances this argument).

[91] *See* BEBCHUK & FRIED, *supra* note 16, at 64–66 (describing the operation of this "outrage constraint" on U.S. executive compensation—and the limits of that constraint).

in turn, should help expose the reasons why Japanese managers do not seek more lucrative pay packages.

2. Foreign Executives' Compensation

A second striking finding revealed by our analysis that merits further research is the fact that foreign executives working for Japanese firms receive much higher levels of total compensation than their Japanese counterparts—on average, over forty percent more. This fact is consistent with the Japanese employment and social norm explanation tentatively offered above, as these norms plausibly would not bind foreign executives working at Japanese firms. But beyond social norms, whatever their strength, comparatively high pay for foreign executives in Japan suggests that simple labor market forces heavily influence Japanese pay.

Simply put, it may be that while non-Japanese executives operate in a global market for managerial talent, most Japanese executives are confined to the domestic market. (Not a single Japanese CEO leads a non-Japanese Global Fortune 500 company). Thus, while foreign executives' pay is influenced by global market standards, Japanese executives may be paid according to a much lower domestic scale. To date, very little research has been done on the relationship between global labor markets for executive talent, executive compensation, and corporate governance structures.[92] Our study suggests that this is a fruitful area for further research.

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92 There is a small literature on the impact of geography on executive pay, but it relies exclusively on U.S. data. *See* Christa H.S. Bouwman, The Geography of Executive Compensation (June 2013) (unpublished working paper), http://faculty.weatherhead.case.edu/bouwman/downloads/BouwmanGeographyOfExecComp.pdf; Simi Kedia & Shivaram Rajgopal, *Neighborhood Matters: The Impact of Location on Broad Based Stock Option Plans*, 92 J. FIN. ECON. 109 (2009).

3. The Link Between Corporate Governance and Pay Structure

While labor market factors may explain the large disparity between Japanese and non-Japanese executive pay within Japanese firms, they do not address the potentially most important result of our analysis—the existence of significant differences in the composition of executive pay between traditional auditor firms and committee firms. What accounts for the existence of parallel compensation regimes operating within Japan? While only additional research can provide a definitive answer to this important question, we outline four possible explanations in order to frame the future research effort.

First, compensation practices may be endogenous to firm structure. Just as the selection of board structure may be driven by each firm's particular industrial organization,[93] compensation practices may be based on firm-specific determinations of the most efficient managerial incentive structures. There may simply be two different types of firms in our data set; efficiency concerns led firms with one constellation of characteristics to retain seniority-based pay practices, while similar concerns led firms with a different constellation of characteristics to adopt performance-based pay structures. While endogeneity cannot be ruled out, it does not find support in our data. Performance-based pay practices are significantly correlated with the committee structure even after controlling for other variables that may systematically distinguish the firms in our data set. Similarly, recent empirical research finds little support for endogeneity in Japanese board structure.[94] Nevertheless, because our data do not permit us to rule out this explanation, future work should seek to isolate the relationship between governance and pay from other firm characteristics.

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93 See Gilson & Milhaupt, supra note 7, at 362 (drawing on the insights of Harold Demsetz & Kenneth Lehn, *The Structure of Corporate Ownership*, 93 J. POL. ECON. 1155 (1985)).

94 *See* Eberhart, *supra* note 42, at 188–89.

Second, firms may choose performance-based pay to signal adherence to global governance standards that are, or at least are perceived to be, superior to Japanese practices. Performance-based pay may be associated with the committee system and outside directors because together they constitute a complementary package of institutions widely perceived outside Japan to deliver higher quality corporate governance than insider-dominated boards and pay packages without significant performance-based incentives. Several results of our empirical analysis support this signaling hypothesis. For example, as compared to auditor firms, committee firms have a higher percentage of foreign stockholders, and a lower percentage of ownership by traditionally management-friendly shareholders (Japanese banks and corporate shareholders). While only two founder firms in our data set have adopted the committee system, these firms seem comfortable with—and have reasons to signal adherence to—global governance norms.[95] The signaling theory of executive pay is also consistent with research showing that the committee system confers a value advantage (in the form of Tobin's Q) as compared to the auditor system.[96] Future empirical research should explore whether governance and compensation choices allow Japanese firms to signal their credibility to outsiders.

Third, it is possible that investors view performance-based compensation as part of a familiar and generally desirable package of governance arrangements. Because investors generally lack the time or incentive to scrutinize these arrangements, they may simply demand the wholesale adoption of an "off-the-rack" package of structures. And,

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95 Approximately fifty-seven percent of Eisai's sales are generated outside Japan and its CEO, Haruo Naito, has an MBA from the Kellogg School of Management. Foreign investors, including JPMorgan Chase and Deutsche Bank, own fifty-four percent of Hoya stock, and Hoya has several independent directors on its board, including a non-Japanese board member.

96 *See generally* Eberhart, *supra* note 42 (finding a significant increase in firm valuation for Japanese companies that adopted the committee system).

because investors likely have more influence on the decisions of companies overseen by independent committees than more traditional Japanese firms, they may be more likely to succeed in convincing boards with an American-style governance structure to adopt that package. In contrast to the signaling explanation, in which the corporation's agents seek to identify themselves as adhering to global governance norms, this explanation places the impetus for adoption of more performance-based pay practices on investors. Future research in this area should explore the potential link between increased investor influence and the adoption of performance-based pay arrangements.

Fourth, performance-based pay may result from the operation of the committee system itself. Recall that a compensation committee comprised of a majority of outside directors is required of companies-with-committees. Independent directors, representing shareholder interests, may be bargaining with managers to ensure that their compensation is closely tied to shareholder wealth. That is, the committee structure may provide a better mechanism for creating performance-linked compensation packages than the auditor system.

Our data, drawn from just a single year of disclosures, do not allow us to rule out any of these explanations. They do, however, highlight the pressing need for research into the actual mechanisms through which governance and executive pay are related in Japan. And, because Japanese companies are free to alter—and, in fact, have altered—both their governance and compensation structures over time, the heterogeneous combination of governance and pay arrangements should provide a rich environment for researchers to explore these questions.

C. Japanese Regulation of Executive Compensation

As we have noted, significant additional study is necessary to understand fully the relationship between corporate governance and executive pay – in Japan and elsewhere. Unfortunately, however, Japan's new disclosure rules are unlikely to provide investors, policymakers, and

researchers with all of the information necessary to evaluate those questions.

In most jurisdictions, including in the United States, compensation disclosure must be provided for those executives with the most influence over corporate decisions – including especially the chief executive and chief financial officers of the firm.[97] Although this approach is not without its drawbacks, it provides investors with compensation information for the managers most likely to influence the firm and its value.[98]

Japan, however, has not taken this approach. Instead, Japanese law requires disclosure of compensation only for executives earning more than ¥100 million.[99] In addition to being arbitrary, in view of the comparatively low levels of executive pay in Japan, this threshold triggers disclosures by only a small number of executives, at a fraction of all publicly traded Japanese firms. Moreover, since "exorbitant" levels of executive pay—however that term might be understood—is not a currently a problem in Japan, the additional data resulting from the focus on Japan's most highly compensated executives does not appear to address a pressing public policy issue.[100] And limiting disclosure to

97 For the American rule, see Regulation S-K, 17 C.F.R. § 229.402(c) (2013) (requiring disclosure of compensation arrangements for the Chief Executive Officer, Chief Financial Officer, and the three other highest-paid executive officers of the firm).

98 For an assessment of the history of this approach in the United States, and its effect on managerial incentives, see Robert J. Jackson, Jr., *Stock Unloading and Banker Incentives*, 112 COLUM. L. REV. 951, 955 (2012) (finding that disclosure requirements imposed upon public-company executives deter managers from diversifying their holdings of company stock, with both salutary and troubling implications).

99 *See* Wakabayashi, *supra* note 45.

100 We acknowledge, of course, that Japanese regulators may be attempting to accomplish objectives unrelated to investors' interests by requiring disclosure of executive compensation. *See supra* note 52. If so, however, it is unclear what those objectives are, and how they would be served by the disclosure regime that Japanese regulators have chosen. Moreover, whether or not regulators hoped to accomplish other goals by requiring disclosure of executives' pay, these rules might also serve the important purpose of providing investors with information relevant to the

this group of executives poses nontrivial methodological problems for researchers, whose work might provide policy-relevant insights.[101]

Downward revision of the disclosure threshold may thus be useful, not only to researchers interested in the expansion of academic knowledge, but to investors and regulators with concrete concerns about how Japanese firms are run. Alternatively, the disclosure obligation could be revised in the manner of the U.S. federal securities laws, which emphasize disclosure for the managers who exercise significant control over the firm and its operations, regardless of the level of their compensation. Either reform would allow the Japanese disclosure regime to give researchers and investors information more useful to the understanding of corporate governance and executive compensation.

Beyond the context of executive compensation, we note that our study offers insight as to whether Japanese corporate governance practices are changing in response to over a decade of significant legal reforms and exposure to global market forces—a question on which commentators are currently divided. Many are skeptical. For example, in previous work, one of us concluded that, based on evidence from the first year of adoptions of the committee structure, introduction of the committee system was not a meaningful governance reform.[102] Another recent study has concluded that "Japan's 'traditional' style of corporate governance has emerged relatively unscathed from its contact with 'global standards.'"[103] A separate view is that Japanese firms

governance of Japanese public companies. As we explain in the text, relatively minor changes to these rules would bring the regime significantly closer to serving this purpose.

101 As we have noted, the limitations of the dataset make it impossible to draw definitive conclusions about pay practices at all publicly traded Japanese firms. Although we have taken steps to address the potential bias in our sample, we cannot completely rule out the possibility that sample bias affected our results.

102 *See* Gilson & Milhaupt, *supra* note 7, at 370–71.

103 John Buchanan & Simon Deakin, *In the Shadow of Corporate Governance Reform: Change and Continuity in Managerial Practice at*

adhering to the auditor structure have been able to copy important features of the committee firms so as to diminish the differential effects between the two governance systems.[104] Still other commentators, most prominently Ronald Dore, lament that Japanese managers have abandoned more traditional governance structures. He claims that "after less than two decades of missionary activity [by adherents of the Anglo-Saxon model], the conversion of Japan to the theology of shareholder sovereignty seems complete."[105]

The evidence presented in this Article provides a more nuanced perspective. Traditional boardroom practices plainly still prevail in Japan, but they are no longer ubiquitous. A small group of firms has broken away in favor of governance structures, including compensation practices, resembling those prevalent in the United States. Much more research into the impact of the new structures is needed. But the early evidence does not support the claim that Japanese corporate governance has been unaffected by global standards. Nor does it support the view that traditionally governed Japanese firms have successfully mimicked all of the important innovations of committee firms. In short, the evidence suggests that Japan's conversion to shareholder sovereignty to date has been partial and limited, not wholehearted. At the same time, however, executive pay in Japan indicates that Japanese corporate governance practices—and not just formal laws—are being influenced by global market forces.

Listed Companies in Japan, *in* CORPORATE GOVERNANCE AND MANAGERIAL CHANGE IN JAPAN 28, 45 (D. Hugh Whittaker & Simon Deakin eds., 2009). *See also* Tadashi Araki, *Changes in Japan's Practice-Dependent Stakeholder Model and Employee-Centered Corporate Governance*, *in* CORPORATE GOVERNANCE AND MANAGERIAL CHANGE IN JAPAN, *supra*, at 222, 226 ("changes have occurred to the legal framework, but traditional practices remain firmly in place.").

104 Eberhart, *supra* note 42, at 180.

105 Ronald Dore, *Japan's Conversion to Investor Capitalism*, *in* CORPORATE GOVERNANCE AND MANAGERIAL CHANGE IN JAPAN, *supra* note 103, at 134, 161.

V. CONCLUSION

Lawmakers around the world have increasingly insisted that publicly traded corporations adopt corporate governance and executive pay standards that draw heavily on the American corporate-law context. Little is known, however, about how these standards influence corporate actors abroad—and how they interact with each other in the vastly different regulatory environments in which they have been adopted.

In this Article, we have provided the first direct empirical evidence on the magnitude and structure of executive pay for Japan's most highly compensated executives. The data provide a glimpse of an important, and previously unappreciated, relationship between corporate governance and executive pay in Japan. Firms that have adopted a committee-based structure for their corporate boards have also adopted performance-based pay structures familiar to American corporate law. And at these firms, boards appear far more prepared to provide executives with pay that corresponds to the size of the firm than their counterparts at more traditional Japanese companies.

The evidence also indicates that global markets are an increasingly important determinant of executive pay inside Japan. Non-Japanese executives earn significantly more than their Japanese counterparts. And the data also show that founding executives are frequently among Japan's highest-paid executives. Because these managers have generally maintained significant ownership of their companies, the link between pay and performance at many Japanese firms may be far stronger than has been previously suggested.

Although the evidence presented here points to important paths for future research, the data offer only a snapshot of the complex institutional interactions between governance and compensation structures outside the United States. To the extent that lawmakers continue to import American-style corporate-governance rules into foreign markets, much closer empirical study of the benefits—and potential costs—of the convergence of global governance will be needed.

APPENDIX

The evidence presented in the Article is based on data drawn by hand from filings that public companies were required to provide in 2010 pursuant to the revised Japanese disclosure ordinance made effective in that year. All of the filings used to assemble the dataset are publicly available, and all of the data used in the Article are available upon request.

A. Data

1. Dataset Assembly

Drawing on public filings by all 152 Japanese firms with executives subject to the compensation-disclosure ordinance in 2010, we hand-collected information for all 269 executives for whom compensation was revealed. The data included information on the salary, bonus, stock options, retirement benefits, and other compensation paid to each individual. We supplemented this information with additional detail on the characteristics of each executive in our sample. We also supplemented the dataset with information on the characteristics of each firm.

a. Executive Characteristics

In addition to compensation information, we supplemented our dataset with biographical information on each executive. As noted in the Article, we drew information on each executive's tenure in her role as well as her stock ownership. We also used details disclosed in the *Yuka Shoken Hokokushko* to determine whether each executive was a non-Japanese serving as an executive at a Japanese firm and whether the executive was a founder of the company.

b. Firm Characteristics

We also supplemented our dataset with firm characteristics likely to be relevant to executive pay.

Drawing from both the new disclosures and the *Yuka Shoken Hokokushko*, we collected information on each firm's size (as measured by market capitalization), use of the poison pill, governance structure, firm value (as measured by Tobin's Q), the percentage of each firm's revenue derived from Japan, the percentage of each firm's shares owned by foreign investors, the number of directors on the company's board, and the number of employees at each firm. As explained below, we used these data to control for firm-specific characteristics when analyzing the relationships described in the Article.

2. Firms Subject to Disclosure

As we have noted, in 2010 the revised ordinance applied only to the 152 firms with executives earning more than ¥100 million per year. Thus, it is possible that these firms are meaningfully different than other public companies in Japan—that is, that the companies in our sample may not be representative of Japanese public companies more generally.

Because we cannot observe individuals' pay at firms not subject to the ordinance, we cannot rule out this source of sample bias. As one check, however, we created a separate, hand-drawn dataset of comparable firms that were not subject to the ordinance in 2010. The comparable dataset consisted of 116 firms chosen by industry to match the distribution of industries among the firms that were required to disclose in 2010. We then compared the 152 firms required to disclose with these 116 firms across eight firm-level characteristics, including, among others, firm size, use of the poison pill, governance structure, and firm value. T-tests of the means across these characteristics indicated no statistically significant differences between the group of firms that was subject to the ordinance and the group that was not. As a preliminary matter, then, the firms required to disclose under the ordinance do not seem to be statistically significantly different from other public companies in Japan, at least with respect to these observable firm-level characteristics.

Nevertheless, we acknowledge that the truncated nature of our sample counsels caution in the interpretation of our results. Thus, for reference, we have included in Table I below the list of firms that were subject to the ordinance in 2010, and therefore included in our dataset:

TABLE I: SAMPLE FIRMS

Air Water Inc.	Kobe Steel	Rohto Pharm. Co.
Ajinomoto Co.	Koito Manufact. Co.	Sankyo Co.
Alpha Systems Inc.	Komatsu Ltd.	Sankyo Seiko Co.
Aoki Holdings Inc.	Komeri Co.	Sankyu Inc.
Aoyama Trading Co.	Konami Corp.	Sanrio Corp.
Artnature Inc.	Kose Corp.	Sony Corp.
Asagami Corp.	Ku Holdings Co.	Sanwa Holdings Corp.
Asax Co.	Kuribayashi Steamship Co.	Sanyodo Books Inc.
Astellas Pharm. Inc.	Kyocera Corp.	SBI Holdings, Inc.
Avex Group Holdings Inc.	Kyokuto Securities Co.	Sega Sammy Holdings Inc.
Benesse Holdings, Inc.	Marubeni Corp.	ShiDax Corp.
BML Inc.	Matsumotokiyoshi Holdings Co.	Shin Nippon Biomed. Labs. Co.
C. Uyemura Co.	Medikit Co.	Shin-Etsu Chemical Co.
Colowide, Ltd.	Megane Top Co.	Shinobu Foods Prods. Co.
Columbia Music Entertainment	Meji Holdings Co.	Shinsei Bank Ltd.
Daiwa Securities Group	Mitani Corp.	Shisedo Co.
Dai Nippon Printing Co.	Mitsubishi Corp.	Simplex Technology, Inc.
Daiichi Sankyo Co.	Mitsubishi Estate Co.	Softbank Corp.
Daikin Industries	Mitsubishi Heavy Indus.	Square Enix Holdings Co.
Dainichiseka Col. & Chems. Mfg. Co.	Mitsubishi UFJ Financial Group	Stanley Elec. Co.
Daito Trust Construction Co.	Mitsubishi Electric Co.	Stella Chemifa Corp.
Disco Corp.	Mitsui & Co.	Sumitomo Corp.
Edion Corp.	Mitsui Fudosan Co.	Sumitomo Elec. Industries
Eikoh Inc.	Mitsumi Group Inc.	Sumitomo Metal Industries
Eisai Co.	Mizuho Financial Group	Suruga Bank
Fanuc Ltd.	Nac Co.	Sysmex Corp.
Ferrotec Corp.	Nakayamafuku Co.	Takasago Thermal Engineering Co.
Fields Corp.	Namco Baindai Holdings Inc.	Takata Corp.
FJ Next Co.	Namura Shipbuilding Co.	Takeda Pharm. Co.
FP Corp.	NGK Insulators	TDK Corp.
Fuji Media Holdings, Inc.	NGK Spark Plug Co.	Terumo Corp.
FujiFilm Holdings Corp.	Nihon Chouzai Co.	Tohokushinsha Film Co.
Fujishoji Co.	Nintendo Co.	Tokyo Printing Ink Mfg. Co.
Fukuda Denshi Co.	Nippon Steel Corp.	Toppan Printing Co.
Futaba Corp.	Nippon Suisan Kaisha, Ltd.	Topre Corp.
Gentosha Inc.	Nissan Motor Co.	Toshiba Corp.
GL Sciences, Inc.	Nissin Foods Holdings Co.	Toyo Suisan Kaisha, Ltd.
Goldcrest Co.	Nippon Sheet Glass Co.	Toyota Motor Co.
Hitachi, Ltd.	Nomura Holdings, Inc.	Tsumura & Co.
Honda Motor Co.	NSK Ltd.	Unicharm Corp.
Hosiden Corp.	Okasan Securities Group, Inc.	Up Inc.
Hoya Corp.	Okata Holdings, Inc.	Valor
Itochu Corp.	ORIX Corp.	VT Holdings Co.
Iwatani Corp.	Olympus Corp.	Wacoal Holdings Co.
Japan Communications Inc.	Omron Corp.	Y.A.C. Co.
Japan Digital Labs.	Panasonic Corp.	Y.S. Food Co.
Japan Tobacco Inc.	Pietro Co.	Yagi & Co.
JFE Holdings, Inc.	Privee Turnaround Group Co.	Yahoo Japan Corp.
Kawakin Holdings Co.	Rengo Co.	Yamada Denki Co.
Kissei Pharm. Co.	Resorttrust, Inc.	Zensho Co.
Kobayashi Pharm. Co.	Rinnai Corp.	

B. Analysis

Below we present the results of multivariate regressions explaining the relationships described in the Article. Because our sample is unbalanced with respect to firm—that is, some firms were required to disclose compensation for

more than one executive, and thus some firms are featured in more than one observation in our dataset—all standard errors are clustered by firm. Mean values and standard errors are presented in parentheses. In the tables below, significance levels of 1, 5, and 10 percent are indicated by ***, **, and *, respectively.

1. Performance Pay and Governance in Japan

To estimate the relationship between governance structures and the extent to which executive pay is linked to performance, we specified a multivariate regression model in which the dependent variable is the percentage of an executive's total compensation attributable to performance-based pay, which includes bonuses and grants of stock and stock options (mean: 22.65%). We code the firm's governance structure as a dummy variable, where 1 represents firms with the traditional statutory-auditor structure and 0 represents firms that have adopted the committee structure. Each model includes a linear control for industry (model (a) in the Tables below) or industry fixed effects (model (b)), and all models include controls for Tobin's Q, the percentage of firm stock owned by banks[106] and the executive's total compensation; correlation coefficients were insignificant across all models and are excluded for concision. To address concerns that our results were related to outliers in our dataset, we separately ran each of the regressions below, in each case transforming the dependent variable to reflect the log of the percentage of the executive's pay attributable to

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106 Because the structure of a company's equity ownership is generally thought to be relevant to both the level and structure of executive pay, *see* Jackson, *supra* note 52 at 658–59 fig. 1, in unreported analysis we separately controlled for the level of institutional ownership in our companies more generally. Our results were unchanged from those described in Tables 2 and 3. However, because bank ownership is generally thought to be highly relevant for purposes of Japanese corporate governance, *see* Randall Morck & Masao Nakamura, *Banks and Corporate Control in Japan*, 54 J. FIN. 319, 320 (1999), we present the results of models controlling exclusively for bank ownership in the companies in our sample.

performance-based compensation. Our results were unchanged.

As noted above, we separately coded each executive with respect to whether she was a foreign executive, a founder, or retired. Each of those characteristics is reflected in dummy controls in the models below. We also separately ran each of the regressions below, first excluding founding executives and then excluding foreign executives. The results were unchanged, and below we report correlation coefficients and significance from the entire sample of 269 executives.

TABLE II: PERFORMANCE PAY AND GOVERNANCE IN JAPAN

	Percentage of Pay Attributable to Performance-Based Compensation (0.2265) (a)	Percentage of Pay Attributable to Performance-Based Compensation (0.2265) (b)
Log of Firm's Market Capitalization	.050** (.023)	.061*** (.020)
Executive Tenure on Board of Directors	-.004** (.002)	-.004* (.002)
Traditional Statutory-Auditor Governance	-0.180*** (.059)	-0.170** (.064)
Industry Fixed Effects?	No	Yes
Observations	269	269
Adjusted R2	0.25	0.41

2. Pay Equity Inside the Japanese Boardroom

To explore the relationship among the difference between top executives' pay and the pay of the average director, firm size, and corporate governance, we specify multivariate regression models in which the dependent variable is the gap between the disclosed executive's total compensation and the

average director's pay at that executive's firm, and including in each model an interaction term between firm size and governance, again coding governance as a dummy variable where 1 represents firms with the traditional statutory-auditor structure and 0 represents firms that have adopted the committee structure. All models include controls for Tobin's Q; correlation coefficients were insignificant across all models and are excluded for concision. All models also include controls for the executive's status as a foreigner, as a founder, or as a retired executive, as well as the percentage of firm stock owned by banks; correlation coefficients are excluded for concision. To address concerns that our results were related to outliers in our dataset, we re-ran each of the regressions below, in each case transforming the dependent variable to reflect the log of the percentage of the executive's pay attributable to performance-based compensation. Our results were unchanged.

To further address the concern that our results were skewed by the sample bias inherent in our dataset,[107] we separately re-ran the analysis below including only the single highest-paid executive at each firm. Our results were unchanged, and below we report results from the entire sample of executives.

[107] *See supra* Appendix A.2.

TABLE III: PAY EQUITY INSIDE THE JAPANESE BOARDROOM

	Gap Between Disclosed Executive and Average Director (109.1) (a)	Gap Between Disclosed Executive and Average Director (109.1) (b)
Log of Firm's Market Capitalization	50.36*** (13.15)	45.68** (18.46)
Governance Structure	675.46*** (192.66)	611.08** (252.40)
Log of Market Capitalization * Governance Structure	-51.73*** (13.75)	-47.30*** (40.87)
Industry Fixed Effects?	No	Yes
Observations	269	269
Adjusted R2	0.21	0.25