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Kevin Engelberg

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# Reining in a Culture of Fraud: Adopting Incentive-Based Regulations to Reform Corporate Governance in Japan

## INTRODUCTION

On July 21, 2015, Toshiba's CEO Hisao Tanaka announced that he was resigning from the corporation to take responsibility for his involvement in an accounting scandal that caused Toshiba to overstate its profits by approximately \$1.2 billion USD.<sup>1</sup> The fraud resulted from of a top-down effort by Toshiba's employees to inflate the company's net income.<sup>2</sup> Top executives at Toshiba set almost impossible profit targets, and pressured employees to meet those targets by any means, including the fraudulent inflation of profits.<sup>3</sup> A lack of internal controls, combined with a corporate culture that demands strict obedience to management decisions, resulted in a fraudulent inflation scheme spanning over a seven-year period.<sup>4</sup> The scandal was ultimately uncovered when Japan's securities watchdog, the Securities and Exchange Surveillance Commission ("SESC"), launched a probe into Toshiba's accounting practices and discovered the misconduct.<sup>5</sup>

Toshiba's fraudulent accounting scandal was not an isolated incident among Japanese corporations. A multitude of accounting fraud scandals regarding overstating profits have occurred in Japan: the Olympus Corporation for \$1.7 billion USD in 2011, IHI Corp. for \$4.6 billion USD in 2007, Nikko Cordial Corp. for \$13.7 billion USD in 2006, and Kanebo Ltd. by 210 billion Yen in 2004.<sup>6</sup> Accounting scandals, like the above mentioned, have serious economic implications on companies and investors.<sup>7</sup> It is not unusual for such

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<sup>1</sup> J. William Carpenter, *Toshiba's Accounting Scandal: How It Happened*, INVESTOPEDIA (Aug. 13, 2015), <http://investopedia.com/articles/investing/081315/toshibas-accounting-scandal-how-it-happened.asp>.

<sup>2</sup> *Id.*

<sup>3</sup> *Id.*

<sup>4</sup> *Id.*

<sup>5</sup> John Boyd, *Key Questions in Toshiba Scandal Still Unanswered*, AL JAZEERA (Oct. 15, 2015, 6:24 AM), <http://www.aljazeera.com/indepth/features/2015/10/key-questions-toshiba-scandal-unanswered-151011075457531.html>.

<sup>6</sup> Dave McCombs, *The 7 Biggest Corporate Scandals in Japan*, BLOOMBERG BUS. (July 20, 2015, 10:38 PM), <http://www.bloomberg.com/news/articles/20150721/toshiba-s-accounting-scandal-ranks-among-japan-s-largest-cases>.

<sup>7</sup> Anita R. Morgan & Cori Burnsid, *Olympus Corporation Financial Statement Fraud Case Study: The Role That National Culture Plays on Detecting And Deterring Fraud*, 10 J. BUS. CASE STUD. 175, 175-76 (2014).

companies to be forced into bankruptcy, causing many investors to lose significant financial worth.<sup>8</sup> Clearly, financial statement fraud has adverse effects on shareholders and must be stopped. However, these instances of corporate misconduct are symptomatic of Japan's record for poor corporate governance.<sup>9</sup> Accounting fraud is only one of many negative aspects stemming from Japan's poor corporate governance regulations, and the lack of corporate oversight has negatively impacted Japan's overall economy.<sup>10</sup>

According to the International Monetary Fund ("IMF"), there is a strong link between the quality of a country's corporate governance regulations and the overall health of its economy.<sup>11</sup> The IMF attributes Japan's weak economy to its lack of corporate governance.<sup>12</sup> Specifically, in this case, these poor corporate governance practices link directly to the abnormally high cash holdings by Japanese companies.<sup>13</sup> In 2015, *The Economist* reported that Japanese companies were holding \$1.9 trillion USD in cash, an amount equivalent to almost fifty percent of the entire Japanese economy.<sup>14</sup> This alarmingly high figure suggests that the lack of corporate governance practices is a large factor contributing to a stagnation of funds amounting to nearly a half of the Japanese economy. Thus, improvements in Japan's corporate governance regulations may not only reduce corporate malfeasance but could potentially spur economic growth.

## I. JAPANESE CULTURE AND BUSINESS

In order to understand why the above corporate governance reform efforts are necessary, it is important to understand how the current top-down culture facilitates Japanese corporate misconduct. Although Japanese public corporations, for the most part, mirror public corporations in the United States (i.e. they have shareholders, a board, and corporate executives), Japanese companies tend to be much more responsive to the demands of their corporate

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<sup>8</sup> *Id.*

<sup>9</sup> *Id.* at 175.

<sup>10</sup> See Chie Aoyagi & Giovanni Ganelli, *Unstash the Cash! Corporate Governance Reform in Japan*, IMF, WP/14/140 (2014), available at <https://www.imf.org/external/pubs/ft/wp/2014/wp14140.pdf>.

<sup>11</sup> *Id.* at 3.

<sup>12</sup> *Id.*

<sup>13</sup> *Id.*

<sup>14</sup> *Business in Japan: Meet Shinzo Abe, Shareholder Activist*, *ECONOMIST* (Jun. 6, 2015), available at <http://www.economist.com/node/21653610/print>.

executives than their shareholders.<sup>15</sup> This skewed interest in favor of corporate executives is influenced by the Japanese tradition of ‘*makoto*’.<sup>16</sup> *Makoto* means to “properly discharge all of one’s obligations so that everything will flow smoothly and harmony will be maintained” above everything else, even truthfulness and honesty.<sup>17</sup> It is based on the belief that social harmony is best achieved through conformity and obedience to authority.<sup>18</sup> In a workplace setting, *makoto* can create a leadership command chain similar to a military hierarchy: the top executives give the orders and all lower level employees are expected to obediently follow them.<sup>19</sup> Understanding such values reveals how corporate accounting frauds can go unchecked over the course of several decades.<sup>20</sup>

In the Japanese business community, subordinate employees are expected to demonstrate a deep level of commitment and loyalty to their corporate managers.<sup>21</sup> Under the principles of *makoto*, it is disrespectful for an employee to speak or act outside the scope of his or her prescribed position.<sup>22</sup> This belief system prevents many individuals from challenging the decisions of their superiors, and discourages them from disclosing any problems that may arise.<sup>23</sup> In return, superiors will often reward their most loyal employees with respect, appreciation, and even promotions.<sup>24</sup> Thus corporate managers are able to consolidate their power by surrounding themselves with employees who are committed to following their orders.

In addition to the values of *makoto*, Japanese ideas of cultural harmony also play a big role in facilitating corporate misconduct. At its core, cultural harmony can be best described by the Japanese proverb, “the nail that sticks out gets hammered down,”—meaning that its better to follow the group than to stand out<sup>25</sup> Thus, “groupthink” dominates Japanese corporate culture.<sup>26</sup>

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<sup>15</sup> Bruce E. Aronson, *The Olympus Scandal and Corporate Governance Reform: Can Japan Find a Middle Ground Between the Board Monitoring Model and Management Mode?* 35 J. JAPAN. L. 85, 100 (2013) available at [https://sydney.edu.au/law/anjel/documents/2013/ZJapanR35\\_05-Aronson.pdf](https://sydney.edu.au/law/anjel/documents/2013/ZJapanR35_05-Aronson.pdf).

<sup>16</sup> Morgan & Burnsid, *supra* note 7, at 177.

<sup>17</sup> *Id.*

<sup>18</sup> *See id.*

<sup>19</sup> *See id.*

<sup>20</sup> *See generally id.*

<sup>21</sup> *See id.*

<sup>22</sup> *Id.*

<sup>23</sup> *See id.*

<sup>24</sup> *Id.*

<sup>25</sup> Julian Ryall, *Scandals Soil Japan’s Corporate Giants*, SOUTH CHINA MORNING POST, (Nov. 22, 2015, 12:00 PM), <http://www.scmp.com/business/companies/article/1880062/scandals-soil-japans-corporate-giants>.

Oftentimes, employees will use groupthink to rationalize the validity of impermissible acts by concluding that other employees exhibit the same behavior.<sup>27</sup> Under such cultural norms, widespread corporate fraud is easily achievable and oftentimes goes unnoticed.

The traditional Japanese values of duty, authority, and harmony are so highly valued that individuals are taught to avoid disrupting social tranquility.<sup>28</sup> Thus, it is easy to turn a blind eye to corporate governance conflicts in order to avoid upsetting or destabilizing the social environment.<sup>29</sup> These cultural concepts and beliefs provide insight as to how the Olympus accounting fraud, Japan's largest known accounting scandal, persisted for almost two decades.<sup>30</sup>

## II. THE OLYMPUS ACCOUNTING SCANDAL

To date, Olympus is Japan's third largest accounting scandal.<sup>31</sup> Over the course of twenty years,<sup>32</sup> Olympus was able to hide approximately \$1.7 billion USD in losses from investors.<sup>33</sup> The scandal stemmed from the management's policy of demanding that overly aggressive profit targets were met.<sup>34</sup> Unable to meet these excessively high targets, employees set up complex schemes to accelerate profits and bury losses, even using outside consultations for the sole purpose of financial statement fraud.<sup>35</sup> The fraud persisted for 20 years, and not one whistleblower came forward.<sup>36</sup> Viewed under the cultural principles described above, it is understandable why such practices continued for a long-time.<sup>37</sup>

In the case of Olympus, former CEO Tsuyoshi Kikukawa held all the power to control the company.<sup>38</sup> Contrary to public companies in the United States, board members and executives in Japan do not have clearly distinct

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<sup>26</sup> Morgan & Burnsid, *supra* note 7, at 177.

<sup>27</sup> *Id.* at 176.

<sup>28</sup> *Id.*

<sup>29</sup> *Id.*

<sup>30</sup> Aronson, *supra* note 15, at 88.

<sup>31</sup> McCombs, *supra* note 6.

<sup>32</sup> Aronson, *supra* note 15, at 88.

<sup>33</sup> McCombs, *supra* note 6.

<sup>34</sup> Aronson, *supra* note 15, at 88.

<sup>35</sup> *Id.* at 89–91.

<sup>36</sup> *See id.* at 88.

<sup>37</sup> *See infra* Part II.

<sup>38</sup> *See* Morgan & Burnsid, *supra* note 7, at 177.

spheres of power.<sup>39</sup> This lack of power separation essentially allowed Kikukawa to act as both the President and Board Chairman of Olympus, providing him with unlimited authority to make all personnel decisions, even at the Board level.<sup>40</sup> Kikukawa promoted only the most loyal employees to the Board, essentially rendering the Board ineffective.<sup>41</sup> The Board became beholden to the CEO to such an extent, that an investigative report revealed the Directors were merely “emasculated” company “yes-men.”<sup>42</sup> All demands for greater profits, regardless of feasibility, were met using any means necessary, including the inflation of financial figures in a display of loyalty.<sup>43</sup>

When Kikukawa demanded greater profits, his inferiors were all too willing to meet those targets by any means necessary.<sup>44</sup> In a display of both loyalty and social harmony, employees made a concerted effort to inflate financial figures.<sup>45</sup> Employees’ overriding instinct was to hide any and all mistakes regardless of the costs.<sup>46</sup> Company loyalty was so great that no one ever bothered to blow the whistle or criticize the actions.<sup>47</sup> Olympus fell victim to groupthink.

After two decades of deceit, the Olympus scandal was discovered when Michael Wood, Olympus’ first non-Japanese CEO, became a whistleblower.<sup>48</sup> Wood became suspicious after witnessing an employee attempt to hide a newspaper article that alleged Olympus had engaged in corporate misconduct.<sup>49</sup> Wood launched an internal investigation, and upon discovering the fraudulent acts by former CEO and current Chairman of the Board, Kikukawa, Wood demanded letters of resignation for all board members.<sup>50</sup> The following day, Kikukawa promptly retaliated by firing Wood.<sup>51</sup> The Olympus case demonstrates two major problems that Japanese corporate governance regulations must address: (1) the consolidation of power into a single individual, and (2) the feverous loyalty of subordinate employees.

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<sup>39</sup> *See id.* at 178.

<sup>40</sup> *Id.*

<sup>41</sup> *See id.*

<sup>42</sup> *See id.* at 177.

<sup>43</sup> *Id.*

<sup>44</sup> *See id.*

<sup>45</sup> *Id.*

<sup>46</sup> *Id.*

<sup>47</sup> *Id.*

<sup>48</sup> *Id.* at 175.

<sup>49</sup> *Id.* at 178–79.

<sup>50</sup> *Id.*

<sup>51</sup> *Id.*

In fixing these two major issues in Japanese corporate governance, reform must: (1) separate power between board and executives; (2) incentivize executives to maximize profitability for their company; (3) adequately compensate and protect whistleblowers in order to encourage people to report misconduct. The passage of Japan's very first comprehensive corporate governance code is the first sign that Japan may be moving towards this direction. However, more needs to be done to make the code a cornerstone of Japanese corporate governance.

### III. THE NEW CODES: AN ATTEMPT AT REFORM

In previous years, any attempt at reforming Japanese corporate governance was met with strong opposition by powerful business executives lobbying to maintain the status quo.<sup>52</sup> Despite significant pushback, Japan was recently able to implement two landmark corporate governance reforms: the Stewardship Code ("SC") on February 26, 2014, and the Corporate Governance Code ("CGC"), on March 5, 2015.<sup>53</sup> Described as 'two wheels of a cart', these codes are considered essential to achieving effective Japanese corporate governance regulations.<sup>54</sup> The SC targets institutional investors, while the CGC targets Japanese companies listed on the Tokyo Stock Exchange ("TSE").<sup>55</sup>

The SC is a set of principals meant to encourage institutional investors to be more responsive to their clients and beneficiaries.<sup>56</sup> While the SC is voluntary, over 184 large institutional investors have pledged to abide by its principles on a "comply or explain basis."<sup>57</sup> This allows institutional investors to either comply with the broad principles of the SC, or explain why compliance was not possible.<sup>58</sup> This method allows for quick adoption and implementation across a wide variety of industries and markets, rather than a black-letter law approach prescribing specific actions or conduct that may be unsuitable or impossible achieve.<sup>59</sup> The SC requires that any instances of non-

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<sup>52</sup> *Japan: Landmark Corporate Governance Reforms*, FRESHFIELDS BRUCKHAUS DERINGER 1 (May 2015), [http://www.freshfields.com/uploadedFiles/SiteWide/Knowledge/Japan%20-%20landmark%20corporate%20governance%20reforms%20\(May%202015\).pdf](http://www.freshfields.com/uploadedFiles/SiteWide/Knowledge/Japan%20-%20landmark%20corporate%20governance%20reforms%20(May%202015).pdf).

<sup>53</sup> *Id.* at 1.

<sup>54</sup> *Id.* at 2.

<sup>55</sup> *See id.*

<sup>56</sup> *See id.*

<sup>57</sup> *Id.* at 3.

<sup>58</sup> *Id.*

<sup>59</sup> *Id.*

compliance be included in periodic reports that institutional investors release to demonstrate whether stewardship responsibilities are fulfilled.<sup>60</sup>

In addition to the “comply or explain” method, the SC requires institutional investors to act in the best interests of clients and beneficiaries.<sup>61</sup> To achieve this, the SC requires that an open and honest dialogue be maintained between investors and clients.<sup>62</sup> The SC also emphasizes the importance of achieving medium-to-long-term returns on investments.<sup>63</sup> Critical to long-term success, is an investor actively managing and monitoring investments consistent with shareholder goals.<sup>64</sup> In order to comply with the SC, institutional investors must pressure investee companies to meet medium-to-long-term growth goals consistent with the shareholders’ objectives.<sup>65</sup> The SC increases the responsiveness of corporations who have historically ignored shareholders.

The CGC consists of mandatory principles all companies listed on the TSE and JASDAQ must comply with.<sup>66</sup> The CGC drew inspiration from the United Kingdom’s corporate governance laws, and contains a set of principles and objectives publicly traded companies must observe using a “comply or explain” basis similar to the SC.<sup>67</sup> Unlike the SC, the CGC does allow for non-complying high-growth and emerging companies to be held to a lower reporting standard and does not contain a provision clearly delineating the roles of Board members and corporate executives.<sup>68</sup> Some hallmarks of the CGC include requirements that all companies employ at least two outside board of directors, engage actively with shareholders, and relax corporate measures meant to dissuade mergers and acquisitions.<sup>69</sup> In addition, the CGC requires that Directors owe a fiduciary duty to their shareholders in order to promote medium-to-long-term growth for the benefit of the company as a whole.<sup>70</sup>

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<sup>60</sup> *Id.*

<sup>61</sup> *See id.*

<sup>62</sup> *See id.* at 6.

<sup>63</sup> *Id.* at 2.

<sup>64</sup> *Id.* at 6.

<sup>65</sup> *Id.* at 2.

<sup>66</sup> *See id.*

<sup>67</sup> *Id.* at 3.

<sup>68</sup> *See id.*

<sup>69</sup> *Id.* at 4–5.

<sup>70</sup> *See id.*

The CGC has been in existence for less than a year, and critics are already questioning its effectiveness on improving Japan's corporate governance.<sup>71</sup> Least convincing of the CGC's success was Toshiba's ability to commit accounting fraud while being compliant with the CGC's requirement of appointing at least two outside directors.<sup>72</sup> The appointment of outside directors was largely heralded as a solution for the problematic lack of transparency existing among Japanese corporations.<sup>73</sup> However, it is still too premature to imply that the CGC has failed to improve all aspects of corporate governance in Japan.

The CGC and SC address corporate governance reform by incentivizing positive compliance with corporate governance practices and punishing corporate malfeasance. However, critics argue the CGC and SC need additional strengthening to successfully address specific concerns that general punishment cannot effectively regulate.<sup>74</sup> Moreover, critics fear that companies will superficially follow the CGC and SC without implementing the actual reforms.<sup>75</sup> For both codes to be effective, a "genuine change in outlook" must occur.<sup>76</sup> Only if Japan is willing to back the legitimacy of the SC and CGC with the proper enforcement mechanisms and economic incentives will change be possible. The SESC's recent move to aggressively police corporate misconduct is a positive demonstration of Japan's commitment to back the legitimacy of its new reforms.<sup>77</sup>

#### IV. ENFORCEMENT AND POLICING BEHAVIOR

The Financial Services Agency ("FSA") is the government regulator currently tasked with implementation of the SC and CGC.<sup>78</sup> In order to better understand the effect the codes have on corporate governance, the FSA created the Japan Revitalization Strategy ("JRS").<sup>79</sup> The JRS requires regulators and

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<sup>71</sup> See Masao Nakamura, *Has Japan's Corporate Governance Reform Worked?*, EAST ASIA FORUM (Oct. 23, 2015), <http://www.eastasiaforum.org/2015/10/23/hasjapancorporategovernancereformworked>.

<sup>72</sup> See *id.*

<sup>73</sup> See *id.*

<sup>74</sup> See *Japan Needs to Make New Governance Rules Work*, FIN. TIMES (Jan. 26, 2016, 7:03 PM), <http://www.ft.com/intl/cms/s/0/8bb28aae-c374-11e5-808f-8231cd71622e.html#axzz40Fbq4QWM>.

<sup>75</sup> *Id.*

<sup>76</sup> *Id.*

<sup>77</sup> See *supra* Part I.

<sup>78</sup> See *The First Council of Experts Concerning Follow-up of Japan's Stewardship Code and Japan's Corporate Governance Code*, FIN. SERVICES AGENCY 1, 1–2 (Sept. 21, 2015), available at <http://www.fsa.go.jp/en/refer/councils/follow-up/minutes/20150924-1.pdf>.

<sup>79</sup> *Id.*

industry leaders to periodically meet and strategize about how best to implement reform.<sup>80</sup> Based on the JRS and recent enforcement actions by FSA, there are early signs that policing corporate behavior is a high priority for regulators.<sup>81</sup> While promising, critics are skeptical about whether these current actions will be enough to shift corporate behavior.

Minutes from recent JRS meetings indicate the FSA's top priority is to ensure listed companies appoint at least two outside directors.<sup>82</sup> FSA believes this is key to stemming the tide of Japan's corporate accounting scandals, however, recent events with Toshiba cast doubt on the effectiveness of this regulation.<sup>83</sup> Despite the fact that Toshiba had four outside board of directors, it was still able to pull off one of the largest accounting frauds in Japanese history.<sup>84</sup> The FSA's intense focus on improving board diversity begs the question of whether the agency is superficially implementing rules rather than focusing on dismantling the cultural norms of *makoto* and groupthink prevalent in Japanese culture.

Recently, historic fines were levied on companies engaged in misconduct by Kiyotaka Sasaki, the head of the SESC.<sup>85</sup> Sasaki determined that Japan's past enforcement practices were largely ineffective at reining-in the rampant corporate misconduct plaguing Japanese companies.<sup>86</sup> In the past, it was believed that publicly shaming individuals who were caught for corporate misconduct would deter such future behavior, but Sasaki cited the Toshiba and Olympus scandals as evidence against this practice.<sup>87</sup> Instead of public shaming, Sasaki has decided to employ an approach used by the United States and European Union—levying high fines on the companies themselves.<sup>88</sup>

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<sup>80</sup> *Id.*

<sup>81</sup> See *infra* note 103.

<sup>82</sup> See *The First Council of Experts Concerning Follow-up of Japan's Stewardship Code and Japan's Corporate Governance Code*, *supra* note 78.

<sup>83</sup> *Id.*

<sup>84</sup> See Greg Muraski, *Toshiba's Accounting Scandal: Catching The Fuzzy Math*, SMITH BRAIN TRUST (Aug. 21, 2015), <http://www.rhsmith.umd.edu/news/toshibasaccountingscandalcatchingfuzzymath>.

<sup>85</sup> See Tom Redmond & Takkak Taniguchi, *Japan Watchdog's New Top Man Sees Need for Tougher Punishments*, BLOOMBERG NEWS (Sept. 29, 2015, 7:13 PM), <http://www.bloomberg.com/news/articles/2015-09-29/japns-watchdog-s-new-top-man-sees-need-for-tougher-punishments>.

<sup>86</sup> *Id.*

<sup>87</sup> *Id.*

<sup>88</sup> *Id.*

Sasaki recommended that Toshiba be fined approximately \$59.9 million USD (7.37 billion Yen) for its accounting fraud.<sup>89</sup> In comparison, the second largest fine was held against IHI Corp. for 1.6 billion Yen in 2008.<sup>90</sup> Fines, such as the one levied on Toshiba, hold companies accountable for corporate misconduct, but do not directly impact those orchestrating the fraudulent accounting schemes. Instead, finding ways to hold directors and executive liable may effectively incentivize adherence to proper corporate governance practices.

## V. FUTURE RECOMMENDATIONS

While Japan has taken some crucial steps towards improving corporate governance, additional reform must be done in order to effectively change current corporate practices and legitimize regulators enforcement efforts of the SC and CGC. In order to stop future accounting fraud, the current corporate power structure must be abolished through powerful incentives.

As previously discussed, the concept of *makoto* and groupthink deter whistleblowers. Thus, offering an incentive may help increase reporting of misconduct and decrease abuses of power. Currently, Japan does not offer much protection for whistleblowers and has done little to prevent employers from retaliating.<sup>91</sup> The current law for whistleblower protection does not penalize or punish companies for retaliation against employees, and any fine levied is minimal.<sup>92</sup>

With the potential negative backlash involved with becoming a whistleblower, employees often choose not to report corporate misconduct in exchange for advancing their careers.<sup>93</sup> Japan should consider methods employed by the United States, such as rewarding corporate whistleblowers

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<sup>89</sup> See Taiga Uranaka, *Japan Securities Watchdog Recommends Record \$60 Million Fine for Toshiba*, REUTERS (Dec. 7, 2015, 10:06 AM), <http://uk.reuters.com/article/ustoshibaaccountingfineidUKKBN0TQ0IY20151207>.

<sup>90</sup> *Id.*

<sup>91</sup> See Akihisa Shiozaki & Peter Coney, *The Olympus Effect? Recent Changes to Whistleblower Law Regime*, INT'L LAW OFF. (Aug. 3, 2015), <http://www.internationallawoffice.com/Newsletters/White-Collar-Crime/Japan/Nagashima-Ohno-Tsunematsu/The-Olympus-effect-Recent-changes-to-whistleblower-law-regime>.

<sup>92</sup> Morgan, *supra* note 7, at 179.

<sup>93</sup> See Anna Kitanaka & Isabel Reynolds, *Toshiba Case Points to Whistleblower Law's Shortcomings*, JAPAN TIMES (Jul. 24, 2015), <http://www.japantimes.co.jp/news/2015/07/24/national/crime-legal/toshiba-case-points-whistleblower-laws-shortcomings/#.VsC1WPlrKVM>.

with up to 30% of penalties, damages, or fines recovered by the FSA.<sup>94</sup> With a scheme like this in place, a Toshiba whistleblower may have been entitled to reward around \$18 million USD. A number which may be enough to encourage employees to break makato principles and report corporate malfeasance. Which in turn, would make large scale accounting fraud difficult for corporate executives to achieve.

Another potential for reform involves equating executive compensation with company financial performance and success. Japan could benefit from equating the corporate executive's paycheck with the success or failure of the company he or she manages. In Japan, the average CEO receives 60% of his or her income from salary.<sup>95</sup> While in the United States, the average CEO receives only 10% of his or her income from salary.<sup>96</sup> Incentivizing corporate management through a shift in income source benefits corporate transparency and also allows Japanese CEOs to reduce the gap in pay between their United States counterparts earning, on average, 90% more.<sup>97</sup> By changing how Japanese upper management calculates income, it is possible to incentivize managers into making responsible corporate decisions a priority.<sup>98</sup>

An amendment to the CGC requiring companies to link executive compensation with company-wide financial success through stock options could make this suggestion a reality. Furthermore, executives should be required to forgo a portion of their compensation, in the form of a fine set by the FSA, in the event that corporate misconduct is found to exist.<sup>99</sup> Requiring executives to internalize the successes and failures of their companies may reduce the likelihood of fraud.

Finally, the FSA should work heavily with the TSE to develop a robust framework of penalties for non-compliance with the corporate governance

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<sup>94</sup> See *Qui Tam Explained: What is the False Claims Act? How Does a Qui Tam Case Work?*, PHILLIPS & COHEN LLP, <http://www.phillipsandcohen.com/Qui-Tam-Whistleblowers/Qui-Tam-Explained.shtml>.

<sup>95</sup> See *Japanese CEO Pay Roughly 10% That of US Counterparts*, NIKKEI ASIAN REV. (Nov. 13, 2015, 4:16 AM), <http://asia.nikkei.com/Business/Trends/Japanese-CEO-pay-roughly-10-that-of-US-counterparts>.

<sup>96</sup> *Id.*

<sup>97</sup> *Id.*

<sup>98</sup> See *Japanese Executive Pay: Spartan Salarymen*, ECONOMIST (Jun. 30, 2010, 5:05 PM), [http://www.economist.com/blogs/newsbook/2010/06/japanese\\_executive\\_pay](http://www.economist.com/blogs/newsbook/2010/06/japanese_executive_pay).

<sup>99</sup> See June Rhee, *Holding Corporate Officers and Directors Accountable for Failures of Corporate Governance*, HARV. L. SCH. F. ON CORP. GOVERNANCE AND FIN. REG. (April 16, 2015), <http://corp.gov.law.harvard.edu/2015/04/16/holdingcorporateofficersanddirectorsaccountableforfailuresofcorporategovernance/> (suggesting that executive pay be reduced by 25% in the event a company is fined more than \$10 million and that pay be docked for a minimum of 3 years).

code. Currently, it is unclear whether the “comply or explain” method will result in penalties for the non-compliant company. It is important that the “explain” procedures for non-compliance are not a substitute for adhering to the CGC and SC. In order to be sure this loophole is not exploited, non-complying companies should work with regulators to submit a proposal outlining how they plan to become compliant. Companies under review should also allow regulators to conduct periodic check-ins to ensure that compliance is occurring, and if not, fines should be imposed for continued non-compliance or serious infractions. This will also create an incentive for the public and other industry members to police companies who have fallen out of compliance.

In conclusion, providing economic incentives and penalties may be an effective solution towards addressing Japan’s poor corporate governance practice. The three-pronged approach proposed in this Essay seeks to solve the two major problems causing corporate malfeasance in Japan by building on the developments Japan’s recent reform efforts—the SC and CGC.

KEVIN ENGELBERG\*

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\* Emory University School of Law, J.D., Candidate 2017; Vice President, *Banking and Finance Law Society*; *Emory Corporate and Business Law Society*; Candidate, *Transactional Law Skills Certificate*. I would like to thank my parents for all their love and support; I wouldn’t even be half the man I am today without their guidance.