Toward the policy evaluation for the Japan's Corporate Governance Code : A future outlook

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Corporate governance ; Policy evaluation ; Lab experiment ; Soft low ; Japan's Corporate Governance Code

Ⅰ Introduction

The prevalence of corporate frauds among public listed companies in recent years has an influence on corporate governance[1] regulatory policies and programs (Dewing and Russell 2004). In Japan, for example, the Olympus, Kanebo, and Toshiba scandals are some examples that highlight the influence on regulatory development. These corporate failures have created several Japanese regulatory policies and programs on corporate governance. Japan's Financial Services Agency released the Stewardship Code in 2014. The Tokyo Stock Exchange and the Financial Services Agency jointly published the Corporate Governance Code in 2015.

These movements have temporally created credibility and reliability in the minds of various stakeholders on the regulations. However, past studies provide little evidence on whether the current corporate governance mechanisms are sufficiently effective in providing adequate control in reducing management incentives to engage in fraudulent scandals. Therefore, the purpose of this paper is to examine how to evaluate corporate governance regulatory policies and programs and to prepare the evaluation of the Japan's Corporate Governance Code. This paper is the second step of a series of my governance research projects and a sequel to

1 See Shleifer and Vishny (1997), La Porta, Lopez-de-Silanes, Shleifer, and Vishny (2000) and Bushman and Smith (2001) for the overview of traditional corporate governance researches in finance and accounting.

Taguchi (2014).

This paper proceeds as follows. Firstly, I examine how to evaluate corporate governance regulatory policies and programs and review the theoretical advantages of evidence-based policy making in section two. I also propose the advantage of experimental studies. Secondly, I then develop my thoughts about the evaluation of the Japan's Corporate Governance Code in section three. This section describes some clues for this assessment. Finally, I conclude with a discussion of the implications of my analyses and discuss opportunities for future research in the last section.

Ⅱ Evidence-based policy making : the advantage of experimental studies

In this section, I examine how to evaluate corporate governance regulatory policies and programs, and review the theoretical advantages of evidence-based policy making. I propose the advantage of experimental studies.

In recent years a number of public crises have seized the attention of the world and required rapid and effective responses for policy makers (OECD 2007). The information readily available for policy-making is often unsuitable, although regulatory policies and programs are coming under increasing pressure to show greater accountability. Therefore, evidence-based policy evaluation becomes more important. OECD (2007), for example, shows that policy decisions are based on the best evidence possible and provides the importance of evidence-based policy evaluation and making in education. Guyatt et al. (1992) and Sackett et al. (1996) also provide the importance of evidence based medicine, which is the conscientious, explicit, and judicious use of current best evidence in making decisions about the care of individual patients with the best available external clinical evidence from systematic research.

Table 1 shows three important factors in the literature on evidence-based policy making and evaluation.

Table 1　Important factors for evidence-based policy making and evaluation

	Factors
1	Relation between policy makers and researchers : how to bridge the gap
2	Outcomes : what and how to evaluate *ex ante* and *ex post*
3	Methodology : RCTs and Lab experiments

First, there has been a good deal of discussion on how to bridge the gap between the researchers and policy makers, both in terms of communication of needs and priorities and in terms of coming to an understanding of the different timescales required by each community (OECD 2007, 19). Second, the debate what and how to evaluate the outcomes is also the key factor. In educational policy making, for example, a concern with the outcomes of education (e.g., student achievement) is one of the most significant factors (OECD 2007, 17). Third, the debate regarding appropriate methodology is also imperative. OECD (2007, 23) shows that randomized controlled trials (RCTs) and experiments have received a great amount of attention and are clearly useful for causal questions and provide appropriate outcome. OECD (2007, 23) also shows, however, that RCTs and experiments have both strengths[2, 3] and weaknesses[4] as with all other methodologies and can be proposed as one of a set of appropriate methodologies.

This research takes a look at the issue in the evaluation of corporate governance regulatory policies and programs, the second and third factors are more crucial. Table 2 shows key factors in the corporate governance context and provides two outcomes of policy making in the corporate governance context.

Table 2 Outcomes and methodologies for evidence-based policy making and evaluation in the corporate governance context

Outcomes	Methodologies
1 : Impact on corporate stock values	Archival data analysis
2 : Prevention of corporate frauds	RCTs or Lab experiments

First outcome is an impact on corporate stock values. To get the data of this outcome, an archival data analysis is more appropriate method. For example, Goncharov, Werner, and Zimmermann (2006) use the capital market archival data sample of listed German corporations and evaluate the German Corporate Governance Code (GCGC). They examine a pricing effect connected to the declared degree of compliance with the GCGC and find that the degree of compliance with the GCGC is value-relevant after controlling for an endogeneity bias. Therefore, they show that the capital markets find the rules in the code meaningful and that there is capital market pressure to adopt the Code regulation.

Second outcome is whether to prevent corporate frauds. To get the data of this outcome, RCTs or Lab experiments[5] are more appropriate methods. Experiments have several advantages

2 See Card, DellaVigna and Malmendier (2011) for the usefulness of RCTs.
3 See Kahneman and Sugden (2005) for economic policy evaluation on experienced utility of behavioral economics.
4 See Heckman (1991) for the weakness of the RCTs.
5 Existing many archival data analyses try to examine this outcome although the results are doubtful. Agrawal and Chadha (2005), for one example of archival data analyses, use the capital market archival data sample of U.S. public companies that restated earnings and hand-collected data set that measures the corporate ↗

because a researcher can freely create a controlled economic environment that corresponds to the timeline and the information set of the model, and a researcher can directly observe participants' behaviors. To get the proxies of frauds is difficult for researchers who analyze past archival data. On the other hand, experimental data analyses are suitable to get the proxies of frauds.

Ⅲ A clue about the evaluation of the Japan's Corporate Governance Code

This section provides an overview of the Japan's Corporate Governance Code (hereinafter referred to as JCGC) and a clue about the evaluation of the JCGC.[6]

Ⅲ-1 An overview of the Japan's Corporate Governance Code

The Tokyo Stock Exchange and the Financial Services Agency jointly published the JCGC in 2015 (TSE 2015; Council of Experts Concerning the Corporate Governance Code 2015). The Japan Revitalization Strategy specified that the formulation of a corporate governance code should be based on the OECD principles of corporate governance, therefore the content of the JCGC is based on them and establishes fundamental principles for effective corporate governance.

The core concept of the JCGC is a soft regulation or soft law. Contrary to other forms of hard law or hard regulation such as the Sarbanes-Oxley Act of 2002, the JCGC is a form of soft law or soft regulation, which is voluntary and flexible in its application, built on the market mechanism for evaluation (Cuomo, Mallin, and Zattoni 2016).[7]

Table 3 The core concept and styles of the JCGC

Core concept	Styles of the regulation
Soft regulation (Soft law)	1 : Principles-based approach
	2 : Comply-or-explain regime

Table 3 shows the core concept and the styles of the regulation of the JCGC. The JCGC has two basic styles of the regulation derived from the core concept : The first idea is the principles-based approach, which has firms confirm and share the aim and spirit of the

↘ governance characteristics of firms. Agrawal and Chadha (2005) use the restatement of earnings as the proxy of frauds, restatements data are doubtful for the proxy of corporate frauds because they are often derived from not corporate frauds but mere mistakes of firms.

6 See Cromme (2005) for the German Corporate Governance Code, which is one of the models of the Japan's code.

7 Cuomo et al. (2016) shows a research agenda of corporate governance codes adopted by several countries.

principles and review their activities against the aim and spirit. The second idea is comply-or-explain regime, which has companies either comply with a principle or, if not, explain the reasons why not to do so. In particular, when a company does not comply with some of the principles, it would not be appropriate to conclude automatically that the company has no effective corporate governance.

Ⅲ-2　A hint for the evaluation of the JCGC : Survey on experimental studies

To get a clue for the evaluation of the JCGC, which has the soft-law concept and two styles described above, I survey some experimental studies in this subsection. Table 4 shows the key issues.

First key issue is to assess the adoption of soft law structure by the JCGC. In detail, there are two discussion points on this issue : (a) Commitment effects and (b) Peer effects. The JCGC adopts the soft law structure and accepts principles-based regime, whether to commit or not is an important matter for firms. For the hint for the assessment of this voluntary regime, Nakayachi and Watabe's (2005) experiment may be useful. Nakayachi and Watabe (2005) proposed that voluntary hostage posting raised participants' perceptions of the trustworthiness of organizations that had caused incidents, whereas involuntary hostage posting did not result in more positive evaluations. They investigate the effects of voluntary hostage posting by organizations with self-sanctions in order to restore public trust after adverse events. Nakayachi and Watabe (2005) imply that the commitment by firms for the JCGC is imperative : Higher commitment by firms for the JCGC will result in more positive evaluations. On the other hand, lower commitment for the JCGC will result in more negative evaluations. If the JCGC effectively performs this allocation function by commitment levels, the soft law style adopted by the JCGC is worth "good policy."

Table 4　Key issues to get a clue for the evaluation of the JCGC

1. How to assess the adoption of soft law (voluntary) structure
(a) Commitment effects (Nakayachi and Watabe 2005)
(b) Peer effects (Bateson, Nettle, and Roberts 2006)
2. How to assess the comply-or-explain regime (Davidson and Stevens 2013)

Whether peer effects are effective or not is also one of the important key factors for the evaluation of the JCGC. Bateson, Nettle, and Roberts (2006) show the importance of cues of being watched by field experiments. In detail, they examined the effect of an image of a pair of eyes on contributions to an honesty box used to collect money for drinks in a university coffee room. Their result shows that students paid nearly three times as much when eyes were displayed rather than a control image. Bateson et al. (2006) imply that the firms which adopt the JCGC will be influenced by the "others' eyes" (peer) effects and take a more compliant behavior. Institutional investors that are helped by proxy advisers such as the Institutional Shareholder Services are considered as "others' eyes." The disciplining power of this regime is the required public disclosure of governance practices that allows market participants to evaluate the effectiveness of the firm's governance system. If the JCGC effectively performs this governance power, the JCGC is worth "good policy."

Second key issue is to assess the comply-or-explain regime. This regime requires firms to either "comply" with practices by adopting them or "explain" how they will achieve the underlying principle behind each practice that is not adopted (Luo and Salterio 2014). For the hint of the assessment of this regime, Davidson and Stevens's (2013) experiment may be useful. Davidson and Stevens (2013) examine whether a code of ethics improve investors' trust and managers' reciprocity using Bicchieri's (2006) model of social norm activation, which suggests that social norms must be activated by "situational cues" to be effective. Davidson and Stevens (2013) find that a code of ethics only improved manager return behavior and investor confidence when the code incorporated a public certification choice by the manager. In short, the public certification choice performed as "situational cues," which activated social norms. Davidson and Stevens (2013) imply that the "comply-or-explain" by firms will perform as "situational cues." If the JCGC effectively performs this governance power, the JCGC is worth "good policy."

Ⅳ Concluding remarks：A future outlook

In this study, I examine how to evaluate corporate governance regulatory policies and to prepare the evaluation of the Japan's Corporate Governance Code. The implications of this paper are as follows. First, for the evidence-based evaluation of the policy making of corporate governance, experimental studies have some advantages. Second, the JCGC has soft regulation regimes and has two ideas：the principles-based approach and the comply-or-explain regime. Third, the commitment effects, the peer effects, and situational cues are key factors to get some experimental evidences of the evaluation of the JCGC.

Carcello, Hermanson, and Ye (2011) and Libby, Rennekamp, and Seybert (2015) show that an experimental study will be useful for corporate governance research.[8] RCTs and lab

８　See Brennan and Solomon (2008) and Aguilera, Florackis and Kim (2016) for furthermore corporate governance researches.

experiments have possibility for future research.

Appendix.

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