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Parent control and ownership monitoring in publicly listed subsidiaries in Japan☆

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Although agency theory implies that greater parent ownership can help mitigate agency conflict, principal–principal conflicts could arise among controlling and other minority shareholders. This study investigates corporate governance in publicly listed subsidiary firms after the establishment of small-cap markets, which is a unique setting in Japan. The results show that parent control has a negative relationship to dividend payout and firm profitability. However, parent control enhances sales growth, which is not consistent with parent control exploitation. Foreign shareholders moderate the conflict between parent firms and other shareholders related to dividends and firm profitability.

1. Introduction

Agency theory assumes misaligned interests of ownership and management in publicly listed firms. Under the separation of ownership and control, like that prevailing in Anglo-American countries, principal–agent conflicts among owners (principals) and managers (agents) are problematic (Jensen and Meckling, 1976). On the other hand, under a concentrated ownership structure, majority-owned control engenders more frequent conflicts between controlling shareholders and minority shareholders (Morck et al., 2005). These perspectives of corporate governance represent the principal–principal (PP) conflict structure intended to explain conflicts between controlling and minority shareholders in a firm (Dharwadkar et al., 2000; Young et al., 2008). This study specifically discusses the PP conflict to assess conflicts between controlling and other shareholders.

When external effective corporate governance mechanisms are not fully established, PP conflicts between controlling and minority shareholders might cause severe problems. Parent–subsidiary relations within the business group are expected to be a source of exploitation by parent companies, which provide a unique context in which to study potential conflicts within a business group context. Some studies also investigate conflicts of this kind in business groups (Chang and Hong, 2000; Khanna and Rivkin, 2001). A parent company, due to its large amounts of resources, is expected to control its subsidiaries directly. For example, subsidiary firms that are majority owned by a parent company can expect full control from their parent. In this case, the parent company owns the controlling rights of the subsidiary directly and can make decisions related to the subsidiary's management. Young et al. (2008) point out that PP conflicts result in "purchasing supplies and materials at above-market prices or selling products and services at below-market prices to organization owned by, or associated with, controlling shareholders."

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Even in a developed economy, some conflicts might emerge between parent firms and other shareholders of publicly listed subsidiary firms. Previous studies related to PP conflicts mainly address conflicts between controlling and other shareholders in emerging economies (Young et al., 2008). Although listed subsidiaries with parent firms are not common in the US and EU, it is common for large Japanese firms to list their subsidiary firms on stock exchanges. In addition, Institutional Shareholder Services (ISS) and western media point out the exploitation of minority shareholders in Japanese parent-controlled publicly listed firms. The Financial Times (2005) presents cases of publicly listed subsidiary firms such as Ito-Yokado, a parent firm, and Seven-Eleven Japan, a listed subsidiary. In addition, ISS pointed out that the "practice of listing both the parent and subsidiary has come to be seen as problematic from a corporate governance standpoint." (Financial Times, 2005)

Given the potential for PP conflicts in Japanese parent-controlled subsidiaries firms, we investigate whether Japanese publicly listed subsidiary firms face PP conflict problems empirically. PP conflicts within business groups might occur in Japanese publicly listed subsidiary firms because many parent-controlled publicly listed subsidiaries exist in small-cap markets since the 2000s. Publicly listed subsidiary firms are generally controlled by their parent firms (Financial Times, 2005; Financial Times, 2007a); therefore, parent companies in Japan might control subsidiaries and exploit other minority shareholders (Financial Times, 2007b). However, different from US firms, Japanese firms primarily seek to enhance growth or market share rather than profits (Abegglen and Stalk, 1985). Under these circumstances, parent firms do not exploit listed subsidiaries, but encourage them to emphasize sales growth over profitability.

This paper makes several contributions to the literature. We first apply the PP perspective to publicly listed subsidiary firms in Japan, a developed economy. Second, we contribute to the debate related to publicly listed subsidiaries in Japan. Therefore, our analyses can yield policy implications that apply to potential PP conflicts between controlling and other minority shareholders in Japanese SME markets.

The rest of the article is organized as follows. We next review previous studies of Japanese corporate governance and develop our empirical hypotheses. Then, we explain the data and descriptive statistics in section three. We present the empirical results of the estimation models in section four. Finally, the fifth section discusses our findings and concludes.

2. Literature Review and Hypotheses

2.1. Background

Small subsidiaries in Japan could not be listed on public stock exchanges in the 1980s. In the 1980s, firms used parent-subsidiary relations a beneficial means of diversification (Ito, 1995). After the establishment of small-cap markets in the 2000s, the number of Japanese publicly listed subsidiary firms dramatically increased (Sakawa and Watanabel, 2012). After that, an increasing number of subsidiary firms outside *Keiretsu* business groups were listed. For Japanese family firms, Yoshikawa and Rasheed (2010) find that firms with family board members do not exploit other minority shareholders.

One important feature of the Japanese corporate governance system is Keiretsu or main bank system (Hoshi et al., 1990; Hoshi et al., 1991). Japanese business groups are divided into *Horizontal Keiretsu*, *Vertical Keiretsu*, and *non-Keiretsu.*[1] Eight bank-centered business groups construct *Horizontal Keiretsu* (Mitsubishi, Mitsui, Sumitomo, Fuji, Dai-Ichi Kango, Sanwa, Tokai, and IBJ). The central firms of *Horizontal Keiretsu* aim to secure stable profits in its member firms (Brouthers et al., 2014). Central firms have power dependency (equity, debt, and interlocking board) relations among member firms in unrelated industries to increase their probability of survival and prosperity (McGuire and Dow, 2003). In contrast, *Vertical Keiretsu* are company groups within a *Horizontal Keiretsu*, such as Toyota, that aim to achieve economic efficiency. Thirty-five industrial groups have formed *Vertical Keiretsu*. The other independent firms in Japan that do not belong to *Keiretsu* are *non-Keiretsu* (Choi and Han, 2013; Douthett et al., 2004).

Keiretsu firms have several advantages and benefit from their membership. Using power-dependence theory, Kim et al. (2004) demonstrate that Keiretsu firms outperform non-Keiretsu firms. Keiretsu firms can maintain beneficial relationships with member firms, such as lower transaction costs, shared innovation, lower opportunism, and more stable transactions (McGuire and Dow, 2009; Tabeta and Rahman, 1999). Although Keiretsu members have positive announcement returns for corporate restructuring such as spin-ins, smaller sized firms that do not belong to a Keiretsu cannot gain this positive return (Choi and Han, 2013).

Stock markets in Japan also changed after the 2000s. Young Japanese companies could go public after the establishment of markets for Small and Medium enterprises (SMEs). In 1998, the Tokyo Stock exchange opened the Mothers Section, which is a new market for SMEs. NASDAQ Japan, which worked with NASDAQ, ended its cooperation in 2002. Afterward, NASDAQ Japan joined the Hercules Section of the Osaka Stock Exchange (OSE). One the most representative markets, the JASDAQ, was an over-the-counter (OTC) market before 2004.

Japanese stock exchanges are divided into three primary markets: the Tokyo Stock Exchange (TSE), OSE, and Nagoya Stock Exchange, and several small markets. In general, new public firms tend to list in the section for SMEs in the primary markets. On the other hand, mature firms with larger market capitalization list in the First Section and mature firms with relatively smaller market capitalization list in the Second Section. SME firms are likely to choose the SME section uch as the minimum market capitalization requirement.[2]

[1] Following previous studies (Brouthers et al., 2014; Dow and McGuire, 2009; Kim et al., 2004; McGuire and Dow, 2003), we define *Keiretsu* membership using the list provided by IGJ (Dodwell Marketing Consultants, 1996/1997).

[2] The listing standards for SME sections are less restricted than those for other primary markets such as the First Section of the TSE are (Sakawa and Watanabel,