Re-examining Corporate Governance in Japan

By Yanai Hiroyuki

Current State of Japan's Corporate Governance Theory

Since the collapse of Japan's economic bubble, the mode of corporate management that places the emphasis on the company's employees, dubbed the "Japanese model" and once the object of high regard, has come to be thought of, even in Japan, as inferior to the U.S.-style of corporate governance. A wide array of reforms that emulate the U.S. system have been implemented through both independent action on the part of Japanese companies and through legislation. One model that evidences these changes is the system in which the chief executive officer (CEO) is vested with centralized executive powers, and the board or committees are comprised mostly of independent directors that function separately from the CEO to monitor his or her performance. The gradual adoption of U.S.-style systems in an effort to bring greater efficiency and transparency to management is particularly evident at large listed companies.

Within the current business climate, corporate structures more closely resembling the U.S.-style governance system have been recognized under recent sweeping revisions of the Commercial Code. Under the newly recognized system, companies may elect to establish committees to monitor execution (and eliminate the corporate auditor system), a form of restructuring which will be described in more detail below. Although many aspects of this new system still require adjustments, the new system has improved Japanese legislation regarding corporate governance more than the ineffective legislative efforts to strengthen the function of corporate auditors conducted over the past half-century.

Individual hearings with 90 presidents and chairmen of large companies who are regular members of the Japan Association of Corporate Directors (JACD) revealed that more than 10 companies plan to establish committees to monitor execution in the first fiscal year that it goes into effect (fiscal 2003), with an additional 10 or more companies planning to introduce this system in the second fiscal year. Even allowing for the fact that most managers who are JACD members take a more progressive stance on reform than managers at the typical large Japanese company, these figures are quite a bit higher than generally supposed. From these findings we can infer that, of all listed companies (approximately 3,500), roughly 20 to 30 will introduce a structure under which committees to monitor execution will be established in the first fiscal year when the revised legislation goes into effect.

Legislating Corporate Governance Reform – Corporate Auditors or Independent Directors?

The following is a more detailed treatment of the corporate governance reforms reflected in the new legislative changes.

(1) Overview

The fundamental flaw with legislative reform is currently moving in two separate directions – while some revisions of the Commercial Code concerning corporate governance focus on strengthening the functioning of corporate auditors, others focus on strengthening the board's monitoring function.

The "Law for Partial Revision of the Commercial Code and Laws Concerning Special Exemptions to the Commercial Code as Related to Corporate Auditing," a bill initiated by members of the Diet and passed into law on Dec. 5, 2001, is designed to strengthen the functioning of corporate auditors. This law: (1) makes the inclusion of corporate auditors on the board of directors mandatory and vests them with the right and obligation to contribute their views; (2) increases the number of external corporate auditors and toughens the qualifications for this position (stipulating that an external corporate auditor "may not have served as a director or manager or been otherwise employed by the company or any of its subsidiaries prior to his or her appointment"); (3) extends the terms of corporate auditors; (4) vests corporate auditors with the right to express their views regarding the resignation of an corporate auditor; and (5) vests the board of auditors with the right to approve and propose auditor candidates. In so doing, this law enhances corporate governance by strengthening the position and authority of the corporate auditor.

By contrast, the primary feature of the drastically revised Commercial Code advocated by the Legislative Council of the Ministry of Justice is that it offers a different framework from the conventional corporate structure monitored by corporate auditors. This revision establishes the new above-mentioned optional system under which committees to monitor execution would be founded. The objective in founding these committees is the diversification and rationalization of management methods at corporations and other entities. This revision was passed into law in May 2002 and will go into effect from April 1, 2003.

(2) Outline of Major Commercial Code Revision

Issued in April 2001, the "Interim Plan for the Outline of Proposed Laws for Partial Revision of the Commercial Code" included an article that made the

Relationship between the Board and the CEO

– Newly introduced relationship
between the corporate board and the CEO at Japanese companies
(at firms electing to establish committees to monitor execution) –

election of at least one independent director mandatory without distinction for all large companies. Following the announcement of this plan, this particular article drew strong criticism, with those opposed frequently citing the shortage of qualified persons to serve as independent directors and the loss of corporate autonomy they felt would result. In response to this opposition, the article was excluded from the bill ultimately submitted to the Diet, and the revised law that was passed in the end does not make the election of independent directors mandatory. Although the election of independent directors was not mandated for all companies without distinction, the formation of a "major asset committee" does require the election of at least one independent director. Moreover, at least two independent directors must be elected when a company opts to establish committees to monitor execution. These two scenarios are discussed below.

First, the aim of the formation of a major asset committee is considered to provide the operating committees of top management established under conventional business practices a legal status, and to clarify that the board of directors has the authority to monitor the operating committee. This revision permits the formation of a major asset committee by resolution of the board at large companies with independent directors on their boards and at least 10 board members. This committee is to be composed of at least three board members and is to be able to make decisions regarding items conventionally included under decisions to be made exclusively by the board of directors. The revised Commercial Code recognizes the body conventionally thought of as the operating committee as the highest decision-making body regarding the disposal and transfer of major assets (generally defined as the equivalent of 1% or more of the company's capital), as well as large-scale debts and other management items requiring an extremely high degree of flexibility.

Second, when companies elect to establish committees to monitor execution, they are required to set committees and a corporate executive officer system in their articles of association. The reasons behind these requirements lie with the fact that companies have too many board members (there are still a large number of companies with 30-40 board members or even more) and that the majority of board members are also employees of the company. In order to improve the current situation where corporate boards malfunction as both decision-making and monitoring bodies, this system was designed to separate execution and monitoring authorities, both of which boards of directors have been vested with under conventional corporate structures.

(3) Framework for Establishing Committees to Monitor Execution

In order to ensure flexibility and efficiency in management, power and authority is centralized with the CEO at companies electing to establish committees to monitor execution. To check the power held by the CEO, however, the monitoring function of the board is strengthened through the creation of committees comprised mostly of independent directors. An important aspect of this system is the ability of the board of directors to remove the CEO from office in crisis situations. Accordingly, the two systems under this structure – the committees comprised mostly of independent directors and the corporate executive officer system under which power and authority is centralized with the CEO – complement each other, and must therefore be introduced in tandem. Considered in reverse, the committees comprised mostly of independent directors must function properly, and sound corporate management must be protected if a corporate executive officer system is to be introduced. In this corporate executive officer system, the CEO can single-handedly make decisions that he or she was unable to reach without corporate boards' resolutions in the past.

Three types of committees are required under this new structure: audit committees, nominating committees and compensation committees. The board of directors has the right to elect and remove the directors who create these committees. Committees are to be comprised of at least three board members, the majority of whom must

be independent directors. Accordingly, companies must have at least two independent directors on their boards if they desire to adopt a structure under which committees to monitor execution would be established.

Moreover, although the establishment of committees to monitor execution is possible with two independent directors, the inclusion of two independent directors on a board is not enough by itself. Having one independent director serve as a member of multiple committees is in and of itself inadvisable. The latest revision merely deems two independent directors satisfactory for the time being in deference to the practical difficulties involved in engaging a larger number of independent directors. A situation in which the majority of board members come from outside the company, as is the case in the United States, is preferable, as are regulations prohibiting board members from holding concurrent posts on multiple committees.

The following gives a more detailed view of these committees.

The duties entrusted to an audit committee involve monitoring whether corporate executive officers are managing the company in a fair and proper manner that complies with the basic management policy and mid to long-term management plans adopted by the board of directors. The mission of this committee is to review the level of progress made on mid to long-term plan targets and to ensure audit management efficiency. As such, it is vested with broader powers than conventional corporate auditors have had. Audit committees are the bodies that carry out the board of directors' monitoring function set forth in Article 260, Paragraph 1 of the Commercial Code now in force.

This committee was modeled after the U.S. audit committee. While the U.S.-style committee traditionally conducts the audits required by law that focus mainly on accounting data, Japanese audit committees take on certain auditing functions required by law that had been carried out by conventional corporate auditors, in addition to their role of evaluating the degree to which the objectives set by the board of directors have been achieved.

The nominating committee formulates the proposals regarding the election and removal of corporate directors that will be submitted to shareholders' meetings. The board of directors, however, retains the authority to appoint corporate executive officers and remove them.

The compensation committee sets the amount of compensation each member of the board of directors and each corporate executive officer is to receive. The compensation committee's determination represents the final decision on these matters.

Corporate executive officers' duties involve determining and performing the execution of the business decisions entrusted by the board of directors.

As this new system has been established in order to separate the monitoring and execution functions, directors who serve in the capacity of a representative role or are also employed by the company will be unable to perform the execution functions they have conducted as directors in the past and will need to hold concurrent positions as corporate executive officers.

(4) Independent Directors and Corporate Executive Officers

The basic authority of the boards of directors at corporations in Japan has traditionally lain in the board's power to prescribe the business practices to be executed and to monitor the company's directors and corporate executive officers in the execution of their duties. Namely, the board of directors comprised of at least three board members elected at the shareholders' meeting have the authority and the obligation to determine corporate policy regarding business execution and to elect a representative director, who is vested with the authority to execute these decisions, while also monitoring the representative director and the executive directors in the performance of their duties.

Corporate Auditors (and the board of auditors) are charged with the monitoring function in order to supervise boards of directors vested with this degree of power, since the board is not only the body charged with the monitoring function, but is itself also a decision-making body. Without corporate auditors, the board is left monitoring itself. The position of previous company law has been to ensure that the board of directors' execution is supervised through a body of corporate auditors formed outside of the board.

The highest decision-making body, the shareholders' meeting, is vested with the authority to elect the directors who are charged with corporate management. At the same time, this body is also vested with the authority to elect an audit committee that is independent from the board of directors. This committee serves as a monitoring body to ensure that the appointed directors do not manage the corporation in such a manner as interfere with the shareholders' profits.

In reality, however, the body with the power to make decisions regarding the appointment and termination of corporate auditors is the board of directors. These board members are precisely the parties affiliated with the CEO who are supposed to be in the position of being monitored, which leaves the practical efficacy of the auditing performed by corporate auditors in doubt. To remedy this shortcoming, company law has been repeatedly revised to ensure the independence of corporate auditors by establishing regulations that obligate large companies to appoint external corporate auditors. Despite these efforts, this problem has not yet been entirely resolved.

As more corporate auditors are appointed from outside the company and gain greater independence, they would seem to strongly resemble independent directors. There is a distinct difference, however, between the audits and monitoring of management performed by corporate auditors, and the monitoring of management performed by the board of directors. This difference lies in the power to remove the president or CEO of a company. The ultimate form of authority a monitor has to exert when it is discovered that a

CEO has been mismanaging a company or is involved in scandal is the power to remove this person. Under conventional corporate models, the board of directors appoints the CEO, and although corporate auditors may be allowed to attend these meetings and offer their views on the subject, they do not participate in the board's decision-making.

By contrast, the structure based on the principle of separating monitoring and execution, under which committees to monitor execution will be established, vests the audit, nominating and compensation committees, as well as the corporate executive officers, with the authority to remove the CEO. Recognizing that the present corporate board system does not handle both decision-making and monitoring functions, this new system separating the execution and monitoring bodies was proposed to allow for more flexible management and to ensure a more efficient monitoring function.

The corporate executive officer system was formulated in response to calls from the economic community to centralize the authority to dispose of major assets with the office of the CEO. Without concurrent measures, however, a company would be unable to contain a CEO who acts recklessly. It is therefore necessary to institute a system that acts as a check on the power of the CEO. This need has led to the establishment of a framework under which the monitoring function of the board is strengthened through committees comprised mostly of independent directors, and corporate executive officers are vested with greater executive functions. The economic community has also advocated providing greater flexibility in the establishment of committees to monitor execution by permitting corporations to introduce either the three committees or the corporate executive officer system without requiring the introduction of both. The introduction of the corporate executive officer system, however, must be paired with the creation of the three committees in order to overcome the vulnerability of autonomous management supervision mechanisms, thereby ensuring sound and effective management, as well as providing the means to replace the CEO in crisis situations.

In this case, the decisions to be made by the board of directors include: the formulation of basic management policy and dividends; development of a risk management system for management; the election and removal of corporate executive officers; and the division of corporate executive officer duties and the supervision of directives. All other decisions fall under the authority of corporate executive officers.

There is, however, a great deal of opposition to the introduction of independent directors. Although phrased more roughly, criticism leveled at this system amounts to the question, "What do those from the outside know about our company?" Conventional boards of directors were generally comprised of members who had spent half their lives with the company as an employee. They were part of the corporate family, as it were. It was therefore assumed that these board members would be familiar with the company's business practices and share in the corporate culture and history of the firm, and it was from this culture that the decisions of the board of directors were made. The central criticism of the independent director system stems from uncertainty that, not having been a member of the corporate family, these board members would not be capable of properly analyzing the company's business practices in order to come to an appropriate decision. If they were unable to do so, critics doubt that independent directors would prove to be useful board members.

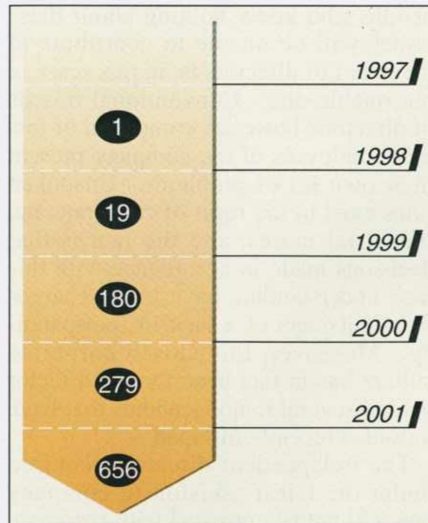
The possibility that independent directors would be ignorant of the business practices at a particular company must be acknowledged. Although directors with experience in the same industry likely possess a certain level of knowledge, not all independent directors will be engaged from rival companies in the same industry, which means that boards of directors will be partly comprised of members with little specific knowledge of the company's management practices. The argument that people who know nothing about these issues will be unable to contribute to the board of directors is, in this sense, a reasonable one. Conventional boards of directors, however, comprised of former employees of the company present their own set of problems. Unspoken rules exist in the form of corporate and industrial mores, and the fact is that decisions made in accordance with this tacit understanding have led to charges from outsiders of a lack of transparency. Moreover, this closed corporate culture has in fact been the main factor behind several major scandals that have unfolded recently in Japan.

The independent directors required under the latest revision to company law will not be entrusted with corporate management. The requirement was introduced solely in response to the need for "directors" who take a third-party stance in monitoring management. These board members are engaged to play the role of monitor with regard to the CEO's management decisions based on a certain degree of common sense and discernment, which does not require specialized expertise in corporate business practices. It will naturally be easier for a director from an entirely unrelated field to determine the propriety of the "practical wisdom" in specific industries, practices which no one within the company would think to challenge, practices which have become embedded within industries but which are unacceptable to the general public.

Of course, corporate governance will not be improved by the mere introduction of independent directors. As is often cited, this restructuring will be meaningless if a CEO simply packs the board with his or her own friends and acquaintances, an issue that falls ultimately in the realm of "human nature." Ensuring the integrity of independent directors is also problematic, but these issues can be resolved to a certain degree by focusing on the system under which independent directors are elected to the board of directors.

In legal terms, independent directors are defined as, "directors who do not execute business transactions at the

Figure 1 Companies introducing Corporate Executive Officer system



Source: Japan Association of Corporate Directors

large corporation; who have not served as director or manager or otherwise been employed by the large company or its subsidiaries; and who do not presently serve as a director employed by its subsidiaries, or as a corporate executive officer or manager or are otherwise employed at either the large company or its subsidiaries." The terms outlined in this definition are, of course, insufficient if independent directors are truly expected to function in a monitoring capacity, and the concept of the nonpartisan director should thus be introduced.

Moreover, corporate executive officers entrusted with the execution of business transactions are given enormous executive powers at companies electing to establish committees to monitor execution, and officers who do not hold concurrent positions as directors are able to devote themselves more exclusively to their execution responsibilities. Above all, a growing number of companies have recently begun to focus on accelerating decision-making processes as major, bold corporate restructuring takes place. In the past, boards of directors have needed to meet to discuss each issue of fund procurement and other matters. Under the new system, most of these decisions will be entrusted to the discretion of the CEO alone.

The responsibility that corporate executive officers have to the company in terms of executing business transactions, however, will remain unchanged. In fact, to the extent that these officers are granted broader powers, their responsibility to provide explanations for their actions and to bring about results will likely be more closely scrutinized than it has been in the past.

Approaches by Specific Companies

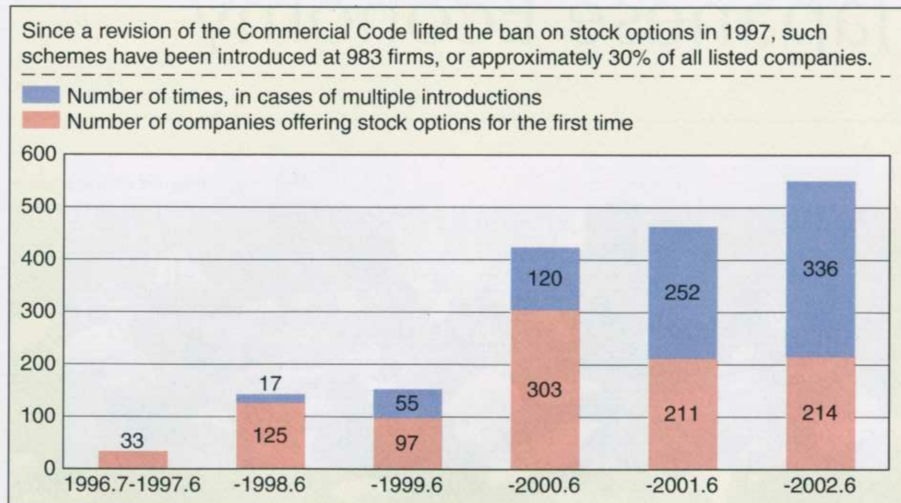
Apart from the legislated corporate governance reforms described above, a number of companies are voluntarily implementing their own governance reforms (reforms not required by law).

These voluntary corporate reforms focus mainly on the board of directors. The board of directors at Japanese companies, for example, has traditionally included dozens of board members, the majority of whom were also executive directors. Although these directors attend board meetings as representatives of their specific department, they lack a company-wide perspective on management. Moreover, with all board members in positions subordinate to the president, these boards of directors were criticized for not fulfilling their obligation to monitor the company president. An initial step in separating the execution and monitoring of management has been taken with the introduction of the "corporate executive officer system," which is designed to slim the board of directors and create a meeting structure under which constructive debate can take place. The position of "officer" at U.S. corporations has been adapted to suit Japan's distinctive corporate environment. Data related to the corporate executive officer system indicates a steady rise in its introduction. Although Sony Corp. was the only company to introduce this system in 1997, this figure subsequently grew to 19 companies in 1998, 180 in 1999, 279 in 2000, and 656 in 2001. (Figure 1) With the phrase "corporate executive officer" adopted by the revision of the Commercial Code, among other reasons, to provide the corporate executive officer system being introduced with legal backing, we have a prime example of the business sector setting the pace and affecting legal change. Moreover, a significant number of corporations have voluntarily established nominating committees, compensation committees and other subordinate bodies that report to the board of directors. These voluntary committees differ from the three mandatory committees required at companies electing to establish committees to monitor execution in that they lack the authority to make final human resource and compensation decisions. These voluntary committees are merely responsible for preparing proposals that are then submitted to the board of directors. (This lack of authority is rooted in the fact that, prior to the revision of the Commercial Code, the board of directors was vested with the final decision-making power to draft the proposals submitted at the shareholders' meetings with regard to human resource planning, the allotment of compensation for individual board members and other matters.)

A number of companies have also moved beyond the corporate executive officer and committee systems and are, in fact, outpacing the legislative system in their efforts to introduce U.S.-style boards of directors.

Hoya Corp., for instance, is a corporate leader in this respect. This corporation has already instituted a board of six directors of whom three are independent directors. With half of the board comprised of independent directors, the Hoya president can be removed from office in a crisis situation on the edict of the independent members alone. While the form taken may not yet be clear, the number of companies establishing voluntary committees to discuss directors' human resource issues (under a variety of names including the "Nominating Committee," "Nominating and Compensation Committee" and "Executive Human Resource Committee") under the auspices of, or independent from the board of directors is expected to climb considerably. The aim of those companies is to create a framework under which the

Figure 2 Corporate Introduction of Stock Options



Source: Towers Perrin

views of corporate outsiders are reflected in the decision-making process.

Beyond restructuring the board of directors itself, many companies are also focusing on restructuring the board of directors compensation system. An evident corporate trend away from the conventional system based on fixed salaries to one that rewards individual performance by increasing the amount of compensation linked to concrete results has, in fact, emerged.

One means by which this is being done is the introduction of stock options to ensure that stockholders and executives have the same vested interest in the company's performance. Since 33 companies introduced stock options in 1997, this number has risen to 142 companies in 1998, 152 in 1999, 423 in 2000, 463 in 2001 and 550 in 2002. (Figure 2) With the introduction of this scheme, however, Japan has begun to face the same variety of problems as other countries in this regard. Stock options allow the recipient to mitigate his or her risk by not exercising the right to this option when a company's performance deteriorates or the stock price falls. Some argue that, considering this scheme in terms of its original objective of maximizing stockholders' profits by equalizing the stakes held by executives and stockholders, compensation should instead be provided in the form of spot shares.

Slow but steady progress is also being made in terms of the transparency of executive compensation. Although compensation for directors has traditionally been an item on the agenda at shareholders' meetings, it was not possible to determine the specific amounts of compensation for individual directors within this framework, and in practice these meetings merely determined the total amount of compensation to be provided to the entire board. The specific amount of compensation for individual board members within this total amount was, therefore, entrusted to the board of directors, which may have subsequently reassigned this matter to the representative director. This meant that in most cases information on the exact level of compensation received by each director was not made available to all. On the other hand, the United States has the common practice of releasing the amount of compensation received by a company's five highest-ranking executives. This fact sparked strong criticism of the practice at Japanese companies as lacking in transparency. In response, Japanese companies have recently begun to review the practice of releasing information on executive compensation. Tokyo Electron, for instance, notifies its shareholders beforehand of the individual compensation received by a total of four executives – two representative directors and two directors – in the notification enclosed in invitations to upcoming shareholders' meetings. Even companies that have actively pursued reform in the area of corporate governance, however, are less than aggressive when it comes to releasing this information. Tokyo Electron represents a rare instance of a company that has taken radical steps in this regard.

Conclusion

The latest drastic revision to the Commercial Code has created an environment in which three corporate structures coexist in Japan: (1) the conventional corporate structure (with a corporate auditor system only); (2) the intermediate corporate structure (with both a corporate auditor system and a major asset committee); and (3) the new corporate structure (under which the corporate auditor system is eliminated and the three committees and the corporate executive officer system introduced).

Now that options beyond the conventional institutional structure, which has traditionally been the only legal option for all corporations without distinction, have been made available to Japanese companies, it is difficult to predict which of the three structures they will choose, or whether these revisions will bring substantial corporate changes to Japan. The final assessment of these three corporate structures should be left to the verdict of the stock market. With a fairly well developed stock market and the fundamental impact this mechanism is beginning to have on socioeconomic factors in Japan, today's investors use corporate structure as one of their considerations in determining whether or not they will invest in a company. The definitive factor in surviving today's global competition is likely to rest with whether these companies make choices that are acceptable to investors. JJTI

Yanai Hiroyuki is the executive director and chief operating officer at the Japan Association of Corporate Directors.