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Changing Japanese Corporate Governance

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Japan Changes: The New Political Economy of Structural
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Changing Japanese Corporate Governance

Christina Ahmadjian

Abstract

This paper examines the rhetoric and reality of corporate governance reform in post-bubble Japan. I argue that the process of corporate governance reform in Japan is neither one of convergence to a "global standard" nor one of inertia, and rather reflects the theme of permeable insulation taken up by other contributors to this volume. Japanese firms are increasingly adopting practices long associated with U.S. corporate governance: small boards, independent directors, and stock options. While these changes have attracted much publicity, they signify relatively little for corporate governance. Boards remain insider-dominated, and the authority of boards of directors *vis a vis* the CEO has been unchanged. Despite the spread of stock options, executive compensation is only minimally tied to the stock market, and disclosure of executive pay remains far from transparent.

Changing Japanese corporate governance

Introduction

Japan is experiencing a corporate governance crisis. Corporate governance has been transformed from an obscure concern of financial economists and legal experts to front-page news. Corporate misbehavior and economic doldrums are blamed upon lack of concern for shareholders, cozy cross-shareholding relationships between firms and banks, boards of directors that look more like old boys clubs than responsible monitors, and executive compensation packages that give CEOs little incentive to improve the bottom line. Foreign institutional investors travel to Japan to promote governance reforms. Managers of large Japanese companies complain that existing governance practices hinder efforts to compete globally. On a more macroeconomic level, reforms in financial accounting regulations, sales of cross-held shares, increased foreign investment, and ongoing negotiations for a revision of the Japanese Commercial Code, all are transforming the political and economic institutions that have until now, supported a distinctive, Japanese system of corporate governance.

These changes in corporate governance are extremely important to understanding political and economic change in the Japanese economy. A corporate governance system comprises a wide range of practices and institutions, from accounting standards and laws concerning financial disclosure, to executive compensation, to size and composition of corporate boards. A corporate governance system defines who owns the firm, and dictates the rules by which economic returns are distributed between shareholders, employees, managers, and other stakeholders. As such, a nation's corporate governance regime has deep implications for firm organization, employment

systems, trading relationships, and capital markets. Thus, changes in Japan's system of corporate governance are likely to have important consequences for the structure and conduct of Japanese business.

As with many aspects of economic and political change in Japan, debate on the prospects of corporate governance reform tends to be framed around two extremes of convergence and inertia. Those who predict convergence argue that global capital and product markets will inevitably drive Japanese firms to a "global standard"--or more specifically, American practice. Some proponents of the opposite viewpoint argue optimistically that existing Japanese governance institutions are effective and do not require dramatic reform. Others argue pessimistically that inertia and fear of upsetting the status quo make change impossible.

In this paper, I argue that neither convergence nor inertia fully explains the trajectory of corporate governance reform in Japan. Rather, corporate governance reform in 1990's Japan reflects the theme of permeable insulation that runs though this volume. Firms are increasingly adopting practices long associated with U.S. corporate governance: small boards, independent directors, and stock options. They argue that Japanese firms must adopt a "global standard" of corporate governance to assure that Japanese firms remain competitive in a global economy. Yet these changes are of far less consequence than the amount of publicity they have received suggests. Stock option grants are small, and boards, though reduced in size, remain insider-dominated. Japanese firms have been markedly reluctant to make changes that would increase the influence of outsiders on boards, and true independent directors remain rare. Firms have also been reluctant to implement changes that would undermine the authority of the company president, or *shacho*, to appoint and dismiss directors, approve their compensation levels, and select his own successor.

In this chapter, I examine two pillars of corporate governance: executive compensation and board composition. I explore the introduction of stock options (legalized in 1997), and several aspects of board reform, including the *shikko yakuin*, or corporate executive officer, system, independent directors, and the ongoing debate over the merits of the *kansayaku*, or statutory auditors. The material presented comes from my field research and includes information collected from extensive interviews with corporate executives, bureaucrats, academics, investors, and others involved in governance reform. I have also relied considerably on the extensive written documentation on corporate governance, ranging from proposals for reform to opinion surveys, that has emerged from various study groups and organizations over the last decade.

Corporate governance

In its broadest sense, corporate governance refers to a complementary set of legal, economic, and social institutions that protect the interests of a corporation's owners. In the Anglo-American system of corporate governance these owners are shareholders. The concept of corporate governance presumes a fundamental tension between shareholders and corporate managers (Berle and Means, 1932; Jensen and Meckling, 1976). While the objective of a corporation's shareholders is a return on their investment, managers are likely to have other goals, such as the power and prestige of running a large and powerful organization, or entertainment and other perquisites of their position. In this situation, managers' superior access to inside information and the relatively powerless position of the numerous and dispersed shareholders of the American firm, mean that managers are likely to have the upper hand.

Economists have offered a number of solutions for this agency problem between shareholders and managers. In general, these solutions fall under the categories of incentive

alignment, monitoring, and discipline. Incentives of managers and shareholders can be aligned through practices such as stock options or other market-based compensation (Fama and Jensen, 1983). Monitoring by an independent and engaged board of directors assures that managers behave in the best interests of the shareholders (Fama and Jensen, 1983). CEO's who fail to maximize shareholder interests can be removed by concerned boards of directors, and a firm that neglects shareholder value is disciplined by the market through takeover (Jensen and Ruback, 1983).[1]

In the late 1980's and early 1990's, researchers' interests moved beyond the boundaries of the U.S. to consider the distinctly different governance regimes found around the world (LaPorta, Lopez de Silanes, et al, 1998; Charkham 1994, Roe 1994). Japan was a particular focus for this interest, since Japanese corporate governance diverged so widely from U.S. practice (Schaede; 1994). In contrast to the U.S., Japanese managers did not take it for granted that shareholders were the ultimate owners of the firm. Rather, a Japanese firm sought to balance a wide range of stakeholders, including creditors, employees, managers, and business partners (Fukao 1995; Aoki 1990. Specialists on the Japanese economy identified a number of mechanisms that, taken together, constituted an effective system to protect the interests of these stakeholders. Influential main banks monitored firm performance, and provided both discipline and resources to those in financial trouble (Sheard, 1994; Hoshi, Kashyap et al. 1991; Hoshi, Kashyap et al. 1990). Closely linked business groups, or keiretsu, used ownership stakes and interlocking directorships to monitor not only their investment in each other, but to assure long-term, mutually beneficial business relationship (Gerlach 1992; Gilson and Roe 1993). Administrative guidance (*gyosei shido*), and a system of *amakudari*, in which retired government officials assumed post-retirement

careers as private sector managers assured that relevant ministries kept close tabs on firm behavior (Schaede, 1994).

Until quite recently, experts contrasted the Japanese system of corporate governance favorably with the Anglo-American system (Roe, 1994). The Japanese system, they argued, encouraged patient capital and close sharing of information between firms and their shareholders, which in turn promoted innovation, stability in employment, and interfirm cooperation (Gerlach, 1992). Conversely, the American system, with its shortsighted shareholders, hostile takeovers, and greedy executives held back growth and innovation (Porter 1992).

A corporate governance revolution?

The perception of Japanese corporate governance as effective and worthy of imitation around the world, changed drastically with the burst of the bubble economy in the early 1990's. As the 1990's progressed, *coopureeto gabanansu* or *kigyo tochi*, terms previously virtually unknown except in small circles of legal experts, became common vocabulary among corporate managers and the business press. Committees of corporate executives, investors, academics, and bureaucrats published a barrage of reports, proposals, and surveys, highlighting Japan's corporate governance crisis, and proposing solutions.

There is room for debate over the degree to which inadequate corporate governance was to blame for the bubble economy and the scandals of the early 1990's. It is clear, however, that changes in the Japanese economy in the 1980's and 1990's rendered the postwar system of governance, as described above, less effective. From the mid-1980's, large firms increasingly turned to capital markets rather than banks for funds. Banks had less incentive to monitor firms, and firms less incentive to listen to banks. As banks sold off their holdings of firms' shares as a

response to the banking crisis in the 1990's, foreigners, largely U.S. and European institutional investors and corporations, increased their equity positions. While long term relationships between firms and their trading partners and business affiliates did not disappear in the 1990's, they began to weaken as firms sought cost reductions in the face of a stagnating economy.

The interest in *coopureeto gabanansu* in Japan can best be understood in the context of a corporate governance revolution (though cynics might say fad) that had begun in the U.S. in the 1980's, and was spreading around the world. During the 1980's, corporate governance became a rallying cry for institutional investors such as the California state employees pension fund, CalPERS. Investor activism, a heated market for corporate control, and an increasingly strong rhetoric of shareholder value, fanned by the business press and academics led to what Michael Useem (1996) has termed "investor capitalism," in which a firm's leading, and perhaps sole, objective, was deemed to be maximization of shareholder value. Better corporate governance, through strong, independent boards of directors, and properly "incentivized" managers, was seen as a way to protect shareholder interests.

Interest in corporate governance spread globally. US institutional investors began to demand that non-US firms adopt corporate governance practices similar to those that had spread in the U.S. (particularly, those pertaining to board independence and composition). Interest in corporate governance was high in the U.K as well, especially with the report and recommendations by the Cadbury Committee in 1992 on improving board oversight (Charkham, 1994). The burst of the bubble and stagnation of the Japanese economy coincided with this increasing interest in corporate governance in the U.S. and Western Europe. A spate of corporate scandals--from the sales of tainted milk by Snow Brand, to the hiding of product liability claims by

Mitsubishi Motors, to the cover up of massive stock-trading losses at Daiwa Bank--also heightened domestic interest in corporate governance in Japan.

The visibility of corporate governance in Japan also spread with the increasing participation of foreign investors in the Japanese stock market. Foreign ownership of shares on the Tokyo Stock Exchange grew significantly, from approximately 5% in 1985 to over 12% in 1999 (see Table 1). This increased ownership of shares by foreigners mirrored the decline in bank holdings. Throughout the 1990's, foreign share purchases represented a large proportion of activity on the TSE, and consequently, foreign investors had considerable influence on share prices.

Globalization and the rhetoric of reform

One of the most striking aspects of corporate governance reform in Japan was the widespread acceptance, at least in rhetoric, that Japanese firms needed to adopt a "global standard" of corporate governance, and that that "global standard" most closely reflected U.S. practices. Discussions of corporate governance reform, whether in the mass media, or in reports from government, academics, or other groups, featured little discussion of other alternatives models for Japan, such as German or northern European systems.

For example, the Corporate Governance Forum of Japan, a group of business executives, academics, investors, and journalists that were one of the earliest proponents of corporate governance reform, began their Corporate Governance Principles with a statement emphasizing global compatibility of corporate governance:

"The globalization of the marketplace has ushered in an era in which the quality of corporate governance has become a crucial component of corporate survival. The compatibility of corporate governance practices in an international context has also become an important element of corporate success. The practice of good corporate governance has been a necessary prerequisite for any corporation to manage effectively in the globalized market." (Corporate Governance Forum of Japan 1998: 36)

They went on to make it clear that their notion of corporate governance revolved around a firm's obligation to its shareholders:

"The legitimacy of the *shacho* [CEO] derives from, and is recognized only by his or her sense of dedication and responsibility to the shareholders and their representatives, the board of directors, through the pursuit of the maximization of corporate value (p. 38)."

A range of statements from widely divergent sources similarly reflected this rhetoric of a global standard of corporate governance. A bill proposed by the Liberal Democratic Party to limit director liability for shareholder derivative suits and strengthen the existing corporate statutory auditor system (a bill criticized widely for weakening corporate governance) was couched in language quite similar to that of the Corporate Governance Forum of Japan. "It is time to introduce the Global Standard of corporate governance, looking to the model of the U.S. firms in strengthening the function of outside directors, and to improve focus on shareholders (*Shouji Houmu*, 1998: 54)."

Taken at face value, this rhetoric might suggest that Japanese corporate governance practices would soon converge with this "global standard." Indeed, throughout the 1990's, a number of reforms tied to aligning management and shareholder incentives, or improving monitoring and discipline of top managers, were introduced. Stock options were legalized in 1997 and spread rapidly. Firms began to shrink their boards of directors, and many instituted a system of *shikko yakuin*, or corporate executive officer, to firmly delineate the supervisory function of a board of directors from the operating responsibilities of the top management team. Many firms announced appointments of independent directors. Probably the most famous case was Sony's appointment to its board of Professor Nakatani Iwao, a prominent economist at Hitotsubashi University. This appointment became the center of media attention when Nakatani was forced to resign from his position at Hitotsubashi, a national university, to assume the Sony directorship.

But how deep and thorough have these changes been? And what do they really signify? In the next sections, I will explore these questions through a more detailed analysis of reforms in executive compensation and board composition.

Executive compensation:

As noted above, one pillar of a corporate governance system is a mechanism to align incentives between managers and shareholders. Theoretical treatments of corporate governance have focused upon the benefits of incentive alignment contracts for corporate governance. Stock options, in particular, are a way to align management interests with share value.

Sony was the first Japanese firm to introduce stock options, in 1996. Since actual stock options were still illegal, Sony created a pseudo stock option, through a bit of financial engineering. The ban on stock options was lifted shortly after, in 1997, and by 2000, over 800

firms had adopted stock options (see Table 2). These stock options were, in most firms, granted to members of boards of directors (since Japanese boards of directors tend to be operating managers as well, this means the senior management team).

The process by which the Japanese Commercial Code was revised to allow stock options marked a sharp break from the long-standing process of revisions in corporate law. This bill was introduced directly to the Diet (*giin rippo*), and supported by the ruling coalition of the LDP, Shakai Minshuto, and Sakigake parties, plus the opposition Shinshuto, Minshuto, and Taiyoto parties, without the standard *hosei shingikai* procedure of examination and study by legal scholars. It was passed on May 15th, and became law on June 1, just in time for the late-June rush of shareholders general meetings. Legal scholars criticized this circumvention of the usual lawmaking process, and the willingness of the politicians to drive through a bill desired by big business, without the appropriate study and negotiations among "related parties." A group of legal scholars wrote in the influential legal journal, *Shouji Houmu* (1997): "This bill was put together with the LDP and some people from the business world, and with some ministerial cooperation from the Ministry of Finance and Ministry of Justice. The contents of the bill were unknown to anyone else, until they were finally reported in the newspaper a few days before it was submitted to the Diet." They further criticized the process as "opaque and secretive."[2]

The speedy passage and wide support of the stock option bill may also reflect its very limited substance. Stock option grants are limited to no more than 10% of a firm's outstanding shares, and a firm is required to submit a list of the names of potential grantees for approval by

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[2] What this means for the future of the *hosei shingikai* process is not clear. Shortly after the stock option bill, the LDP prepared another bill for Commercial Code reform, this time proposing a reduction in director liability for shareholder suits, and strengthening the kansayaku system. However, as of Spring 2001, this bill had not been introduced, and had been criticized as anti-corporate governance. A major revision of the Japanese Commercial

the shareholders' general meeting. Unfavorable tax consequences and unfavorable stock market conditions also decrease the attractiveness of stock options.

Stock options, furthermore, have not been accompanied by a fundamental change in how executive compensation is determined and allocated. Only the boards of a handful of firms have independent compensation committees that set compensation for the CEO and top executives. The process by which top management compensation (including that of the president) is set remains less than transparent in many firms. Furthermore, while firms are required to report compensation for directors (i.e. the president and the rest of the top management team) as a whole, very few firms break this figure down by individual. A 2000 survey of 1310 firms by the Tokyo stock exchange found that only 15 disclosed individual directors' remuneration (TSE, 2000: 12). Of the non-disclosing companies, while 17 planned to disclose individual remuneration, 793 said they would not consider it (p. 13). A respondent to this survey explained his company's hesitance to disclose compensation: "We are urged to disclose individual directors' remuneration, but such a disclosure would have an aspect of only satisfying third parties' curiosity. It would be sufficient to provide a fair rule determining the amount of remuneration, e.g. that links individual's performance (p. 24)."

In my interviews, several managers noted that disclosure of compensation and independent compensation committees are neither necessary nor desirable in Japanese firms. Japanese firms do not suffer from the problem of excessive CEO compensation observed in the U.S. One manager noted, based on his own experience on a U.S. board, that compensation committees seemed to be more effective in theory than in practice. While their observations of the U.S. may be appropriate, this does not alter the conclusion that the adoption of stock options among Japanese firms means

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Code, scheduled to be submitted to the Diet in 2002, was being carried out through the usual *hosei shingikai*

little for corporate governance. Stock option grants are small, are allocated by insiders, with no input from representatives of shareholders (e.g. a compensation committee) and in the vast majority of firms, have not been accompanied by moves towards greater disclosure and transparency.

Composition of boards of directors:

The board of directors is another pillar of corporate governance. The board of directors represents a firm's owners, and monitors the CEO to assure that she and her management team are operating in the owners' best interests. If the interests of owners and managers diverge, as is assumed by corporate governance theory, a board of directors will only be an effective monitor if it is independent--and the monitoring capability of a board declines drastically if it consists solely or mostly of insiders.

In 1990, the average U.S. firm had 9 outside directors and 3 inside directors (Ward, 1997: 99). Although outside directors are not required by law, the NYSE requires a firm to have a board with an audit committee consisting of at least 3 "financially literate" independent directors. The dominance of American boards by outsiders is a relatively new phenomenon, historically speaking. In the 1920's to the 1960's, the average big company board had a majority of insiders (p. 61).

Independent boards of directors play an important role in other economies as well. Large German firms are required to have a supervisory board, with representation from both shareholders and employees and unions (the proportion depends upon the specific type of company). While the presence of employee representatives on German boards indicate that German law considers employees, as well as stockholders, as important stakeholders in the firm,

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proces.

German supervisory boards play a critical role in monitoring and, if necessary, disciplining the CEO. Duties of the German supervisory board include approving items including the company's accounts, major capital expenditures and strategic acquisitions, appointments to the management board, and the dividend (Charkham, 1994: 22).

In contrast, Japanese boards rarely play a supervisory role. Though the Japanese Commercial Code stipulates that the board of directors represents the shareholders, and requires that the board approve a wide range of decisions in the best interest of the shareholders, board meetings are usually little more than a formality. One reason is that Japanese boards are very large. A 1990 study of 100 large firms found that board size ranged from 8 to 56, and averaged 30.6 (Takeuchi 1991, cited in Schaede, 1994). The boards of only 19% of the firms surveyed in this study had any outsider at all. And, many outsider directors are not independent. Outside directors tend to be retired government officials, bankers, managers from important trading partners, or parent companies. Furthermore, members of Japanese boards, whether insiders or outsiders, tend to assume operating responsibilities. Usually the top operating executives, as well as heads of important functions and divisions have seats on the board of directors. Japanese boards of directors do not monitor management because they, themselves, are top management.

Boards of directors play a very different role in Japan than they do in the U.S. or in Germany. Board membership in large Japanese firms is the ultimate achievement in the permanent employment system. While not every employee can aspire to be president, director is a more reasonable goal, and boards are large, in part to make that goal attainable to more employees. Board membership also lends a certain cachet--it is said, for example, that boards of general contractors in the construction industry are particularly large to provide enough directors to attend ground breaking and ribbon-cutting ceremonies.

The lack of independence and unwieldy size of Japanese boards have been a particular focus for critics of Japanese corporate governance. CalPERS' corporate governance standards for Japan, for example, promote reduction in board size, and increase in board independence. The Corporate Governance Principles of the Corporate Governance Forum of Japan similarly focus on these issues of board size and independence. Press reports suggest that Japanese companies are responding to these criticisms by reducing board size, separating monitoring and operating functions, and increasing numbers of independent directors. But how meaningful are these changes?

Board size reductions and the *shikko yakuin* system: In 1997, Sony, with great fanfare, reduced its board size from 38 to 10. It renamed the directors removed from the board *shikko yakuin*, and translated this term as "corporate executive officer." The stated objective was to separate strategic decision-making from implementation. Under the *shikko yakuin* system, the board makes the strategic decisions, which the *shikko yakuin* then implement. This system has spread rapidly among large Japanese companies. In a survey conducted by the Tokyo Stock Exchange in September 2000, 35.5% of the respondents had already adopted the *shikko yakuin* system, an increase of 32 points from the previous survey, conducted in 1988 (TSE, 2000: 2).

According to Sony officials, the decision to change the status of 28 *torishimariyaku* to *shikko yakuin* was a wrenching one. The position of *torishimariyaku*, or board member, is the ultimate career aspiration of many a corporate employee, and a change in status to *shikko yakuin* was inevitably seen as a demotion. Sony's chairman wrote a letter to the wives of the new *shikko yakuin* explaining the decision, and made the transition to the new status easier by allowing *shikko yakuin* to keep their cars and other perks of the office of director.

The Sony adoption of the *shikko yakuin* system (as well as stock options, which it also pioneered) is often touted (by Sony itself as well as others) as evidence that corporate governance in Japan is converging with an American system. A closer look at the *shikko yakuin* system, however, suggests that this may not be so. Sony argued that the implementation of a *shikko yakuin* system would improve corporate governance by separating the supervisory and operating functions. The board of directors would supervise the business and keep a holistic outlook on business strategy, while the *shikko yakuin* would pay attention to the operational aspects of business. The rationale behind dividing supervisory and operational functions of a board is to have an objective body that is able to monitor the behavior of managers, and serve the interests of a firm's stakeholders. However, the *shikko yakuin* system entails naming one set of insiders (since the directors tend to remain insiders) as supervisors, and one set as executives. There are certainly many advantages in speed and flexibility to a 10-member board, as opposed to a 40-member board. However, a 10-member board dominated by insiders is unlikely to provide an objective monitoring and supervisory function.

There is also reason to believe that the *shikko yakuin* system is unlikely to result in the greater decision speed and flexibility claimed by its proponents. Corporate boards have largely been a rubber stamp. Real decision making is in the hands of a management committee or subset of directors. Given the fact that decisions are not made, but merely approved, in monthly board meetings, it is not clear how reducing board size makes much difference.

So why the *shikko yakuin* system? Cynics have said that it is a way to reduce liability for shareholder suits, or that it is a way to save on director salaries. My own interviews suggest that it is also be an attempt to shift power away from powerful factories and functional groups that in the past had strong representation on the board. One way, at least symbolically, to switch the balance

of power between strong factories, or strong R&D divisions (examples that I was given), is to demote their heads from the boards, and clearly stipulate that their jobs are implementation, rather than strategic decision making.

While the *shikko yakuin* system may have important implications for how strategic decisions are made, this system, is likely to do little to increase the degree to which the board is able to monitor and discipline senior management. Whether the boards of Japanese firms consist of 10 members or 50, insiders remain dominant. It should also be noted that the move to reduced board size has not been accompanied by any change in the status of the board *vis a vis* the CEO. The board of directors still serves at the discretion of the president. The president, or the president and chairman (usually the retired president or retired executive of a parent company), still select the president's successor. These new, reduced boards may have a broader strategic outlook on the firm's business, and may be less likely to make decisions that benefit their own division, factory, or functional area, at the expense of the firm as a whole. They are unlikely, however, to be better representatives of the shareholders, and are unlikely to play much of a role in monitoring, or disciplining, the top management team.

Independent directors: Another issue that has received high priority in corporate governance reform is appointment of independent directors. Sony has reaped much positive publicity from the fact that 3 of the 10 members of its reduced board are outsiders. However, a closer look suggests that these outsiders are less than independent. Sony's outside directors, for example, include a director from Sakura Bank, Sony's leading bank, and Pete Peterson--a old friend of Sony's since its earliest days in the U.S. market.

Prominent examples such as Sony aside, outside directors remain relatively rare in Japanese firms. The September 2000 survey by the Tokyo Stock Exchange found that only 19%

of the firms had outside directors (see Table 3). Of these firms with outside directors, only 57.5% reported that they had one or more "non-interested," i.e. independent directors.

In my interviews with Japanese executives, the question of outside directors tended to generate the strongest opinions. "Japanese don't accept outsiders" was a response heard from a number of managers. Even a Sony official, speaking to an American Chamber of Commerce in Japan group, said that Sony had no plans for an outsider-dominated board, because that was inconsistent with Japanese culture.

The *kansayaku* system: One of the arguments often heard against increasing the number of independent directors on the board is that Japan already has a system to assure independent monitoring of the board of directors: the *kansayaku*, or statutory corporate auditor system. The fate of the *kansayaku* system has been one of the most hotly contested aspects of corporate governance.

Under the Japanese Commercial Code, a large firm is required to have at least 3 *kansayaku*, and at least one must be an outsider. However, the definition of an outsider is someone who has not worked for a firm in 5 years. Thus "outside" *kansayaku* tend to be retired employees, or managers from closely related banks, subsidiaries, parent companies, or other affiliates. The *kansayaku* were initially included in the 1950 Commercial Code Revision as a substitute for outside auditors, at a time when Certified Public Accountants were scarce. In theory, the *kansayaku* monitor the board of directors for adherence to law, and evaluate the financial reports of the outside auditor.

A number of problems, however, make it difficult for *kansayaku* to be true independent monitors. First, while by law the shareholders' meeting must approve *kansayaku* appointment, in fact, shareholders rarely reject the recommendations of the company president. *Kansayaku* tend

to have limited staff, which limits their auditing activity. A survey of 1,641 listed firms by the Association of *Kansayaku* found that in only 40.8% of listed firms did *kansayaku* have any staff at all, and in these cases, in only slightly over 50% of the time were there more than 1 staff (*Kansayaku*, 1996: 51, 52). Over 50% of listed companies had *kansayaku* budgets of under 2 million yen (p.75) *Kansayaku* have no vote in the board of directors meeting, although they often attend. Moreover, the position of *kansayaku* is often seen as a cut in status as below director--a consolation appointment for someone who didn't make director.

Contention over the future of the *kansayaku* system reflects fault lines between big business, the ministries, and politicians. Two themes emerge: one is increasingly active involvement in policy-making on behalf of big business by the LDP. The other is evidence of contention between big business, i.e. Keidanren, and METI on corporate governance issues.

In September, 1997, the *Jiminto homu bukai shoho ni kasuru iinkai* (LDP law section, committee on the Commercial Code) proposed a set of revisions to the Commercial Code. Several days later, Keidanren came out with a set of virtually identical proposals. There were two important elements to the LDP/Keidanren proposals. The first was the limitation of director liability for shareholder derivative suits. The second concerned strengthening the function of the *kansayaku*. The LDP/Keidanren proposals suggested that with a few improvements, the *kansayaku* system could play the same role as independent directors in the U.S.

In 2000, METI, (formerly MITI) put out its own proposal for revision of the Commercial Code. METI proposed that firms with an auditing committee with over half independent directors be exempt from the *kansayaku* system. A firm could choose either the Japanese *kansayaku* system, or an audit committee dominated by outsiders, and the market would eventually decide which one was more effective. People close to the preparation of this proposal suggested that

METI's original position favored independent directors and the abolishment of the *kansayaku* system and the proposal to give firms a choice between two systems was a compromise, under pressure from Keidanren.

The fate of the *kansayaku* system will be determined when the revised Commercial Code is put before the Diet for approval in 2002. The *hosei shingikai* for Commercial Code reform is said to be leaning towards a system requiring independent directors, though the eventual outcome is not yet clear.

The process of change

I have argued that despite the rhetoric of a "global standard" of corporate governance, and considerable publicity received by new practices such as stock options and the corporate executive officer (*shikko yakuin*), changes have had, in general, little impact on corporate governance. They have done little to increase incentive alignment between managers and shareholders, and they have done little to enhance the ability of the board of directors to monitor and discipline top management. Firms have, however, adopted changes that are relatively small and painless--e.g. stock options as allowed by Japanese law. They have also enthusiastically adopted practices that are beneficial from a managerial perspective--such as *shikko yakuin* system, which promises to centralize and streamline decision-making. Changes that threaten managerial autonomy, such as greater board independence, have spread less widely.

In interviews, managers often attributed this outcome to culture--an inherent Japanese suspicion of outsiders. A closer examination, however, suggests that changes in corporate governance observed to date have little to do with culture. Rather, they reflect the players in corporate governance reform, and the pressures that they have faced. The principal players in

corporate governance reform to date have been corporations themselves. For example, stock options were legalized under strong pressure from corporations. The corporate executive officer system and board size reductions are all changes that have been carried out on the corporate level. The most outspoken proponents of corporate governance reform tend to be leaders of companies such as Sony, Orix, Omron, and Fuji Xerox.

Since a fundamental premise of corporate governance is that the interests of managers and owners diverge, and that mechanisms must be put in place to prevent managers from making decisions that are not in the best interest of managers, it is natural that corporate executives would not be the most enthusiastic proponents of thorough corporate governance reform. Corporate governance reform in the U.S. in the 1980's, for example, was largely due to pressures by institutional investors and the discipline of an active market for corporate control, rather than activity by corporate executives. In contrast, corporate governance reform led by managers is likely to lead to changes that are either innocuous, or in the best interests of managers. A statement of an executive reported in the TSE survey of corporate governance reflects the management attitude towards change: "I will seek our own corporate governance style that matches our own corporate culture." (TSE, 2000: 24).

The names of the companies that have been most active in corporate governance reform suggest that the strongest pressures for corporate governance reform are from foreigners. Sony, Orix, Omron, and Fuji Xerox have high percentages of foreign ownership, and are necessarily responsive to concerns of foreigners. These are firms that also pride themselves on their image as global companies--and corporate governance fits nicely within this theme of globalization.

While the activity of firms such as Sony, Orix, and Omron in corporate governance reform suggest that foreign stockholders are pushing governance changes, it is not clear just how

foreigners exert this influence. Senior managers that I interviewed said that they had very little direct contract with foreign investors until the late 1990's--after corporate governance reforms were underway. Foreign investors that I interviewed, as well, say that they applied little direct pressure on Japanese companies, at least until the late 1990's, when they became more active in meeting directly with senior management teams. Almost every manager that I interviewed referred to CalPERS as an important influence in governance reform in Japan. However, at least among the firms that I interviewed, no firm had been directly contacted by CalPERs about their corporate governance. The managers interviewed suggested that CalPERS Corporate Governance Principles for Japan were particularly influential. These principles are some very general statements about a philosophy of corporate governance and board independence, and have been widely publicized in the press. Even the CalPERS principles for Japan, however, appeared in the 1998, after corporate governance reform had become widespread in Japan.

Japanese institutional investors have to date been relatively quiet on issues of corporate governance. As a pension official told me, "pension fund managers have may other things to do." In 1998, the Pension Fund Association issued guidelines for pensions, and advised them to start exercising voting rights (the usual pattern in the past had been for pensions to instruct the trust banks that held their investment shares to return blank proxy forms, signifying their agreement with management). Exercise of voting rights has become increasingly common over the last several years, but trust banks say that they are rarely given instructions by pensions on how to vote, and are rarely asked by the pensions how they voted. No vocal advocates of corporate governance reform have emerged among Japanese institutional investors.

Another group absent from the debate on corporate governance is labor unions. Japanese corporate executives, in public statements and interviews, have made much of the importance of

employees as stakeholders in the firm. And some corporate governance systems, most notably, the German system, mandate employee representation on corporate boards. (It is interesting, however, that in the course of my interviews, not once have I heard a manager advocate German style employee representation.) Given the weakening role of organized labor in Japan, and the delayed entry of labor into the corporate governance debate, it is unlikely that they will have much influence in the future.

Managers interviewed noted that shareholder derivative suits are an additional, domestic, impetus for governance reform. In 1994, the filing fee for shareholder derivative suits was lowered from a percentage of damages asked to 8,200 yen. As a consequence, shareholder suits rose dramatically as a consequence. In 2000, an 83 billion yen decision was handed down against directors of Daiwa Bank for their negligence in not stopping trading irregularities in the New York branch. Senior executives claim that the specter of shareholder suits has made them more cognizant of satisfying shareholders. They also say that the threat of shareholder suits is making it very difficult to find outside directors willing to serve. It is not clear then, if shareholder suits have encouraged, or discouraged, a move to greater board independence.

DICUSSION AND CONCLUSION

This paper examined changes in executive compensation and board structure in 1990's Japan. I argued that the 1990's saw an upsurge of rhetoric about corporate governance reform. Japanese business executives, bureaucrats, politicians, and the mass media, all urged that Japanese firms adopt a "global standard" of governance, to allow Japanese firms to flourish in an increasingly global economy. This "global standard" of governance largely mirrored U.S. practice: alignment in incentives between top management and shareholders, and greater board

independence to promote better monitoring and firmer discipline. While adoptions of stock options, introduction of the corporate executive officer system, board size reductions, and appointment of independent directors all received considerable publicity, these practices promised to have little impact on corporate governance. Stock option grants have probably been too small to really align incentives between investors and managers. The corporate executive officer system and board size reductions, may have streamlined decision making, and made lines of command clearer, but did little to increase the capacity of a board to monitor and discipline senior management (i.e. the CEO). Independent directors, have, so far, been largely a fiction. And changes in board size and compensation have not been accompanied by other fundamental changes in who appoints and dismisses the president, how managerial compensation is determined and disclosed, and how directors are selected and evaluated.

I argued that this tension between a rhetoric of global capitalism and an actual set of practices, that in fact preserve the power and autonomy of incumbent corporate management, reflects the theme of permeable insulation that runs through this volume. I further argued that this resistance to change that increases board independence and threatens the power and autonomy of incumbent managers has less to do with Japanese culture than to the specific pressures for change. To a large extent, corporate governance reforms are being promoted by corporations themselves. These changes are partially in response to foreign investor pressure. Pressure by domestic investors, however, to date has been virtually non-existent. And even pressure from foreign investors has been relatively indirect.

The future of corporate governance reform in Japan will depend upon a number of factors that are, at this point, unpredictable. Foreign ownership of Japanese shares, though it has increased substantially, remains low. A continuing increase in share purchases by foreigners may

add to stronger pressure for change in corporate governance practices. Foreign influence in the markets should not be overstated. With Japan's high savings rate, it is likely that in the future, domestic investors will play a much more important role than foreigners. As more of Japan's saving are turned over to private money managers (for example, as the government turns a portion of *nenpuku* pension assets over to private managers in the next few years, and if defined contribution pension plans are legalized), Japanese investors, and savers, are likely to show more interest in corporate governance. Finally, the future of corporate governance will depend upon the reform of the Commercial Code, slated to be put before the Diet in 2002. Issues such as the role and number of independent directors, and the future of the *kansayaku* are likely to be resolved at that time.

What does this trajectory of change imply for the future of the Japanese economy? To some extent, the answer to this question depends upon one's faith that U.S. style corporate governance actually improves the performance of firms and economies. As I noted earlier, the empirical evidence that better corporate governance leads to better performing firms is still slim, though investors and increasingly, corporate managers, take it as an article of faith (see, for example, Blair, 1995, for a survey). However, despite a divergence in opinion on the advantages of U.S. style corporate governance, there is considerable agreement that strong, developed economies are based upon effective and coherent systems of corporate governance, which protect the interests of investors. While Japan's corporate governance once received praise for its ability to direct capital investment to the right places and promote economic growth, arguably, few elements of that system remain. With the unwinding of bank cross-shareholdings, and a decline in indirect bank financing that began in the 1980's, the main bank system is disappearing. Administrative guidance, similarly, has weakened. If the mass media is to be believed, long-term

relationships between buyers and seller firms are similarly unraveling. Corporate governance reform in Japan is not a question of a competition between a Japanese and a foreign system, but rather, a question of what will replace a system of corporate governance that has largely disappeared.

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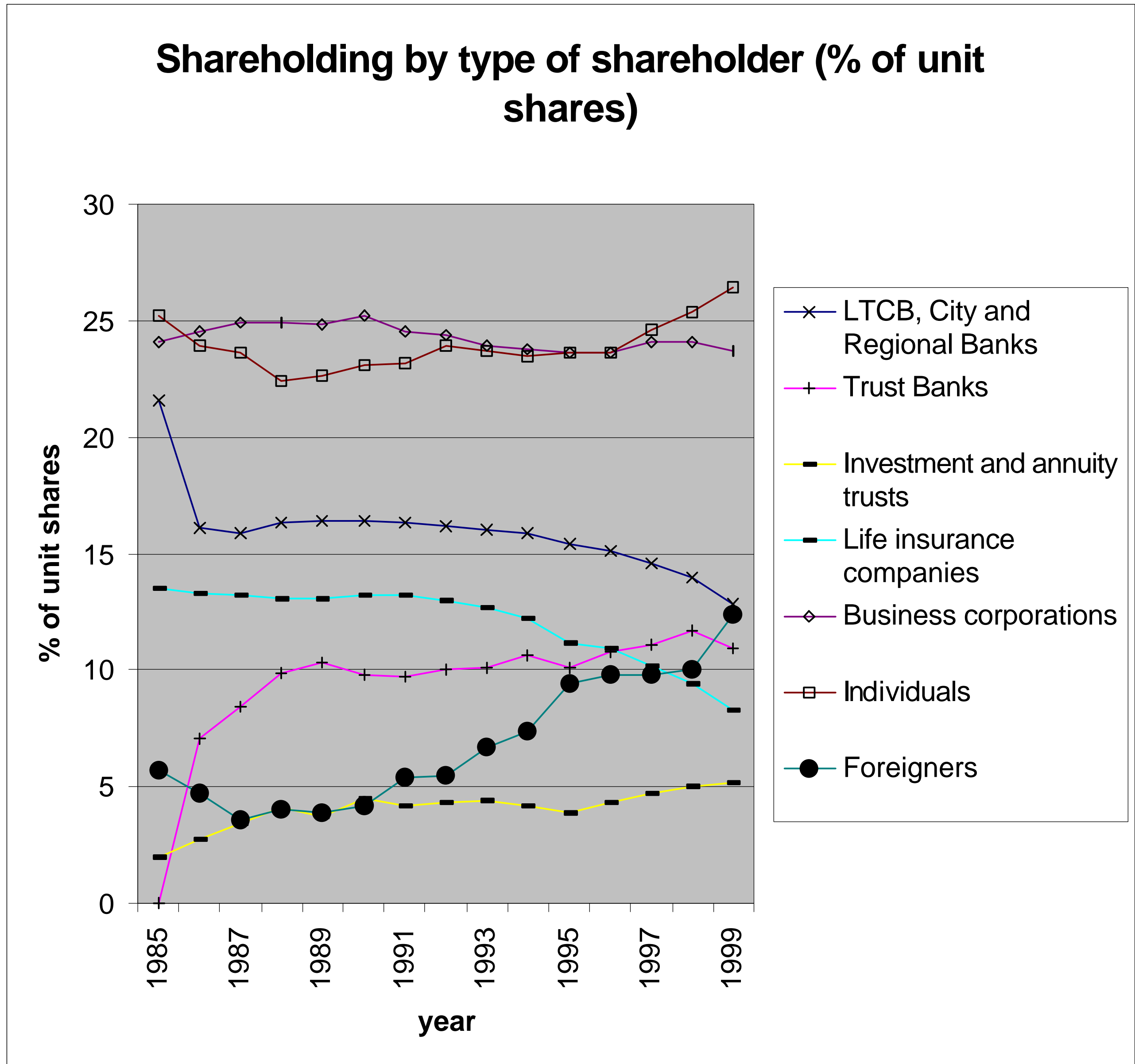
Table 1: Composition of ownership on the Tokyo Stock Exchange over time



Source: Tokyo Stock Exchange

Table 2: Number of firms that have introduced stock options (source: Daiwa Securities)

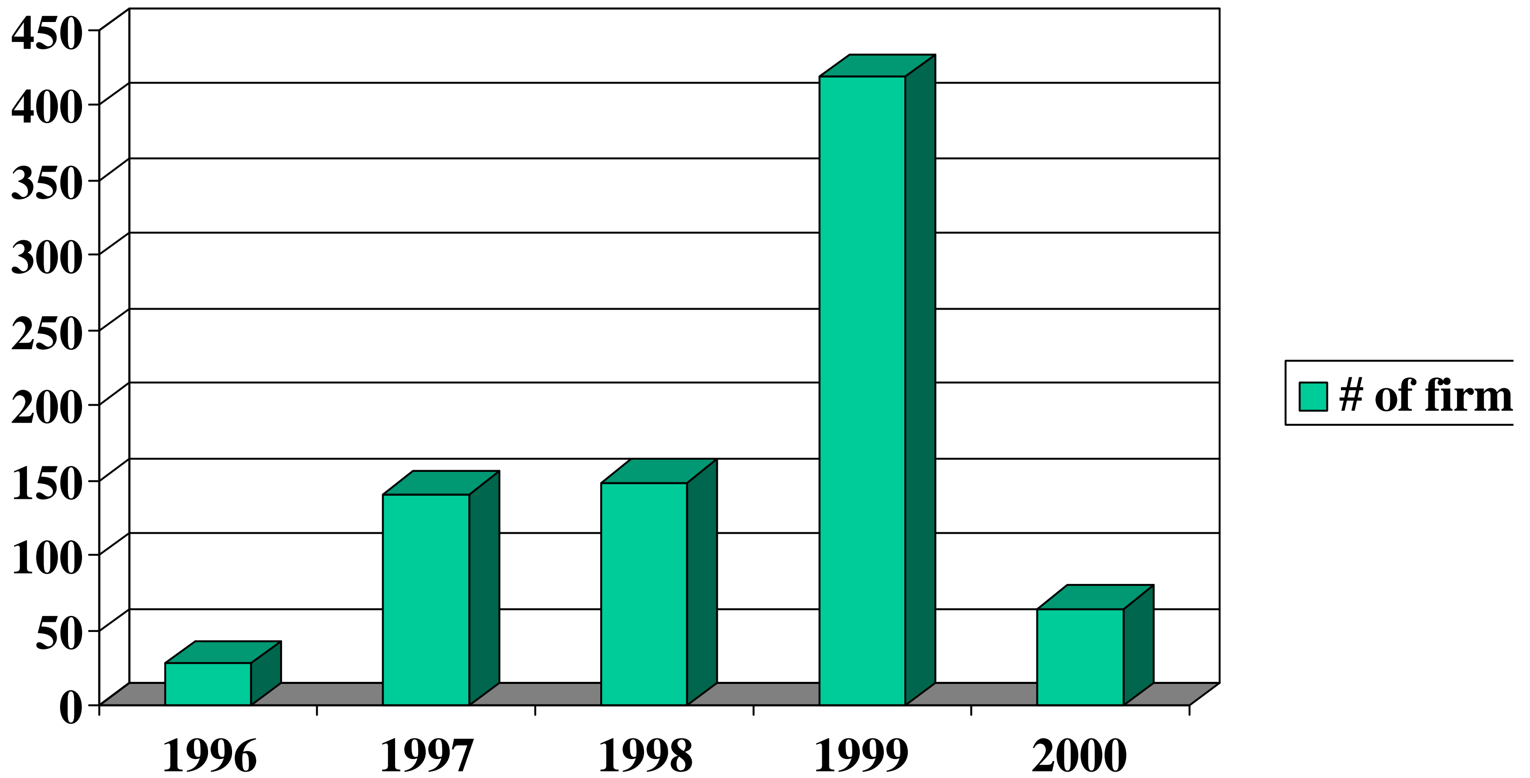
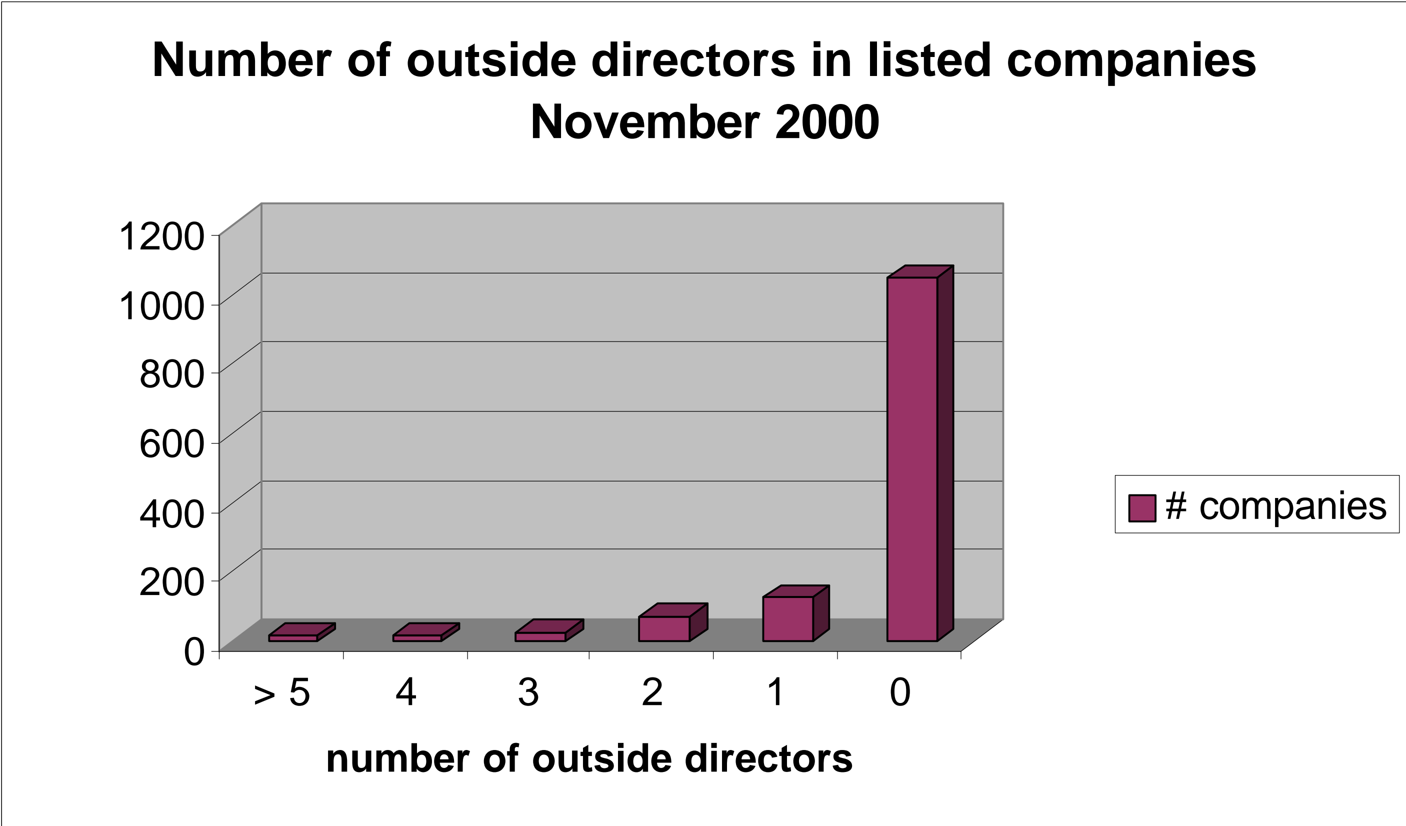


Table 3: Number of outside directors in listed companies



Source: Tokyo Stock Exchange