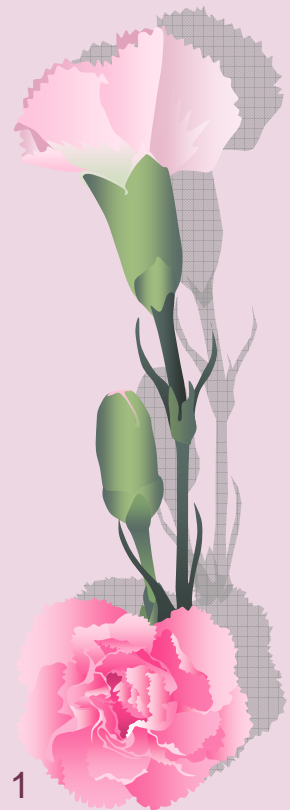


Recent Developments in Japanese Corporate Governance: an Ongoing Reform or a Mere Pretext ?

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I. *Kansayaku* System in Japan

A Unique “*Kansayaku*” System (statutory auditor; corporate auditor) [1] [2]:

- Three or more *Kansayaku* shall be elected by the shareholders’ meeting.
- Each *Kansayaku* engages in - and focuses on- compliance matters.
- *Kansayaku* shall attend board meetings, tell their opinions if they think it necessary; however, they have no voting rights at the meeting.

Reforms in 2001 and 2002

- The 2001 reform (effective in 2002) reinforced *Kansayaku* system.
 - A half or more of *Kansayaku* of the company shall satisfy outside status.
 - (Until the reform, a company was required to have only one outside *Kansayaku*.)
- The 2002 reform (effective in 2003) introduced the “*Committee*” system, similar to American governance system:
 - a company with committees shall elect at least two outside directors.

- Each listed company is supposed to choose between *Kansayaku* and Committee systems. Only 72 (out of approx. 3800) listed companies have chosen the Committee System.
- The Board of *Kansayaku* could be seen as an analog form of an “audit committee,” which has duties and powers on auditing matters on one hand, while it could be thought only as its incomplete substitute because the members lack the voting rights at the board of directors.

II. Criticism from Abroad against Japanese Corporate Governance

Asian Corporate Governance Association (ACGA), “*White Paper on Corporate Governance in Japan*” (May 2008) [3] recommended Japanese companies and government, inter alia, to

- Elect at least three independent directors,
- Protect the existing shareholders against dilutions of their investment by large-scale new share- and share warrant-issuances, by accommodating pre-emption rights to the shareholders,
- Restrict abuse of poison pills, and
- Disclose the numbers of votes thrown in the resolution of the shareholders’ meeting.

(Also see the investors’ opinions collected by the Tokyo Stock Exchange in June to July, 2008. [4])

III. Opinions of Various Organizations in Japan

- *Japan Corporate Auditors Association* (March 26, 2009) [5]
- *Nippon Keidanren* (Japan Business Federation) (April 14, 2009) [6]
- Tokyo Stock Exchange [*TSE*] (May 19, 2009) [7]
- *The Japanese Institute of Certified Public Accountants* (May 21, 2009) [8]
- Ministry of Economy, Trade and Industry [*METI*] (June 17, 2009) [9]
- Financial Services Agency [*FSA*] (June 17, 2009) [10]

ACGA vs. Organizations in Japan

On Independent Directors,

- see Keidanren, METI and FSA.

On New Share Issuances,

- see TSE and FSA.

On Voting Transparency,

- see Keidanren and FSA.

On abuse of Poison Pills,

- see Corporate Value Study Group [sponsored by the METI] Report (2008) [11]; A research project is in progress, sponsored by Japan Securities Research Institute [12].

IV. The Corporate Governance Study Group Report

- Sponsored by METI
- 20 members including 5 from investing firms, 4 from listed companies and business organization, 4 law professors, 2 professors on economics etc.
+ 2 observers from the FSA and MOJ. [13]

1. Fundamental Approach to Corporate Governance

- *“It is not necessary to blindly follow the format of Europe or the United States, but stock markets are borderless, and therefore it is important to have a system that has the potential to foster international understanding.”*
(emphasis added) [14]

2. “Independence” of Outside Board Members (Directors and Kansayaku)

- *“What is really important is the relationship between ensuring “effectiveness” of corporate governance and securing “independence” that does not conflict with the interests of minority shareholders trading shares in the markets. Recent studies show that a trade-off can be found between these two desirable values.”*
(emphasis added) [15]

“Consequently, the Corporate Governance Study Group has concluded that:

- (1) The framework must necessarily assume that, as a minimum, there will be an “independent” director/kansayaku who is not at risk of having conflicts of interest with minority shareholders and who is supposed to protect minority shareholders. Moreover, the legal regulations that listed companies must fulfill should accept diversity in “outsider” status, and will not replace the existing “outsider” requirements with “independence” requirements.*
- (2) As to actions to be taken by individual listed companies, each listed company will be required to improve disclosure of its views in the framework, so that consensus regarding the most appropriate corporate governance structure for each company can be fostered through dialogue with shareholders, taking into account the dual requirements of securing independence while ensuring the effectiveness of governance”. [16]*

(Osugi) Readers may differ in their interpretation of those lines.

The assumption in (1) will probably be promulgated as a self-regulation and/or nonbinding target. If a company listed on TSE adopts *Kansayaku* system and thus appoints two outside *Kansayaku*, it is required by (1) to have one or more independent director/*Kansayaku*, while the remaining outside *Kansayaku* could be “outside but not independent,” such as a person who came from the parent company.

3. Introduction of Outside Directors

“Consequently, the Corporate Governance Study Group has concluded to require listed companies to choose either of options (1) or (2) below:

(1) To have an outside director as a minimum, and to disclose facts concerning the corporate governance system (disclose the role and function of the outside director, etc.);

or

(2) If option (1) is not chosen, to disclose facts concerning the corporate governance system using the company’s own original method”. [17]

(Osugi) A listed company is not legally obliged to have an outside director; however, it must publish its opinions on “good/ best practice” on corporate governance.

4. Selection of Measures

- *“So on this occasion the Corporate Governance Study Group decided to adopt measures that do not require any revision to the law, and concluded that it is realistic to require this to be established by [securities] exchanges”. [18]*

V. Comments

- (1) There are reasons why we are relying not on statutes but on self regulations.
- The reinforced *Kansayaku* system is starting to work; Functionally, *Kansayaku* are coming closer to outside (and independent) directors. We should await and see what's going on for a couple of years before we make a formal, legal reform.
 - In Japan, matters on corporate governance are dealt with by the "Companies Act" (MOJ) while matters on securities transaction by the "Financial Instruments and Exchange Act" (FSA). The governance rules and requirements fall in a pitfall between those two statutes. MOJ and FSA have been closely collaborated with each other in recent legal reforms, but this takes a bit more time.
 - The point must be what rules the TSE will set out in 2009 or 2010.

(2) The way of human networking and the value creation mechanism in Japanese companies may be different from those of western companies.

(a) Relationships among Medieval merchants in Mediterranean trades:

- *Genoa vs. Maghrib*

(b) Relationships among workers in modern companies:

- Typical US Company vs. Typical Japanese Company

(c) Shareholder - Manager Relationships

(a) Relationships between Medieval merchants in distant places.

See Greif (2006) [19] and Aoki (2001) [20]

- *Genoese traders in the 12th century (Latin world) vs. Maghribi traders in the 11th century (Jewish or Muslim):*
 - *Genoese traders*; Due to their high mobility, promises among merchants had become enforced by legal institutions (courts).
 - *Maghribi traders*; Trades were made repeatedly among fixed merchants, and thus one of them who cheated another was expelled from the guild.

(b) Typical US Company vs. Typical Japanese Company

- *US type*; the relationship between a boss and his/her subordinate is close to the straightforward “principal - agent” model.
- *J-type*; collaborations among workers are promoted, and this holds not only among subordinates but between the boss and subordinate(s).
 - Here, person A and B are both principal(s) and agent(s) of each other. Creation of value often comes from information and wisdom on the spot. [21]
 - “[T]he knowledge of particular time and circumstances available to men on the spot” (Hayek, (1945). [22])

(c) Shareholder - Manager Relationship (Hypothesis)

- *US* companies; the relationship between shareholders and the manager(s) is modeled on “principal - agent” relations. The independent director is a device to discipline the agent.
- *Japanese* companies; the shareholders and the managers are both principal(s) and agent(s) of each other.
 - The focal point has been moving from managers to shareholders, and thus the shareholders are becoming more like the principal while the managers more like the agents.
 - However, as long as creation of values comes mainly from the knowledge on the spot, corporate managers do not believe that an independent director who does not experience the spot would be helpful.

(d) Conclusion

- Japanese Companies should keep their strength while they should overcome their shortcomings.
- In the future, a hybrid of US type company and J-type company will emerge.
- To that end, we should
 - foster serious dialogues between investors and corporate managers, and
 - expect a case of success.

*Thank you for
listening*

Notes (Links and References)

- [1] English translation of “Companies Act in 2005” is available at:
<<http://www.japaneselawtranslation.go.jp/law/detail/?re=01&ft=1&ky=%E9%87%91%E8%9E%8D&page=7>> and
<<http://www.japaneselawtranslation.go.jp/law/detail/?re=01&ft=1&ky=%E9%87%91%E8%9E%8D&page=8>>
- [2] An overview of the Kansayaku system in Japan is available at:
< http://www.kansa.or.jp/english/about_02.html> (A webpage of Japan Corporate Auditors Association)
- [3] Asian Corporate Governance Association (ACGA), “White Paper on Corporate Governance in Japan” (2008), at:
< http://www.acga-asia.org/public/files/Japan%20WP_%20May2008.pdf>
- [4] Tokyo Stock Exchange [TSE], “Tosho Jojo Kaisha no Koporeito Gabanansu ni kansuru Toshika Muke Iken Boshu ni taishite Yoserareta Iken no Gaiyo ni tsuite [An Overview of the Opinions from Investors on Corporate Governance of Companies listed on TSE],” at: < <http://www.tse.or.jp/about/press/080826s.pdf>> (in Japanese)

Notes (continued.)

[5] An Advisory Panel with Experts in the Japan Corporate Auditors Association, “On Various Problems on Corporate Governance in Listed Companies” (2009), at:

< http://www.kansa.or.jp/PDF/ns_090403_02.pdf> (in Japanese)

[6] Nippon Keidanren (Japan Business Federation) , “Towards Better Corporate Governance: Interim Discussion Paper on Key Issues” (April 14, 2009) , at:

< <http://www.keidanren.or.jp/english/policy/2009/038.pdf>>

[7] Tokyo Stock Exchange [TSE] “On Improvements of Listing System” (May 19, 2009), at: < <http://www.tse.or.jp/rules/comment/090519-jojo.pdf>> (in Japanese)

[8] The Japanese Institute of Certified Public Accountants [JICPA], “Role of corporate governance and disclosure by listed companies - to improve the credibility of financial information of listed companies” (May 21, 2009) , at:

< http://www.hp.jicpa.or.jp/specialized_field/post_1130.html> (in Japanese)

[9] Corporate Governance Study Group Report (sponsored by the METI) (June 17, 2009), at:

<<http://www.meti.go.jp/english/report/downloadfiles/200906cgst.pdf>>

Notes (continued.)

- [10] The Financial Services Agency [FSA], “Report by the Financial System Council’s Study Group on the Internationalization of Japanese Financial and Capital Markets: Toward Stronger Corporate Governance of Publicly Listed Companies” (June 17, 2009), at: < <http://www.fsa.go.jp/en/news/2009/20090618-1/01.pdf>> (Provisional and unofficial translation)
- [11] Corporate Value Study Group (sponsored by the METI) (2009), “Takeover Defense Measures in Light of Recent Environmental Changes” (June 30, 2008), at:
<<http://www.meti.go.jp/english/report/data/080630TakeoverDefenseMeasures.pdf>>
- [12] Japan Securities Research Institute, “Report on the M&A Practices and Regulations in England,” at:
< <http://www.jsri.or.jp/web/publish/other/pdf/004.pdf>> (in Japanese)
- [13] For the details, see the METI Report (supra note 9), at pages 7-8.
- [14] Supra, at page 2.
- [15] Supra, at page 3.
- [16] Supra, at page 4.

Notes (continued.)

[17] Supra, at page 5.

[18] Supra, at page 6.

[19] Avner Greif, *Institutions and the Path to the Modern Economy: Lessons from Medieval Trade* (Cambridge 2006), at Chapters 3 and 9.

[20] See also Masahiko Aoki, *Comparative Institutional Analysis* (MIT Press 2001), at Chapter 3, Subchapter 2.

[21] See Kazuhiro Arai, *Shuushin Kyo-sei to Nihon Bunka: Geimu-ron teki Apurochi* [Lifetime Employment and Japanese Culture: An Game Theory Approach] (Chuukou Shinsho 1997) (in Japanese). Also see Aoki, supra note 20 at Chapters 4 and 5.

[22] Friedrich Hayek (1945), “The use of knowledge in society,” *American Economic Review* 35: 519-530.