Corporate Governance and Reform of Japan's Commercial Code

Sadakazu Osaki

1. The US Corporate System as a Model for Reform of Japan's Commercial Code

Japanese company law (i.e., those sections of the Commercial Code that regulate corporations) has been subject to numerous amendments in recent years. Since 1997, there have been reforms of one sort or another every year, especially last year (2001), when, in addition to the reforms passed by the Diet in regular session in the spring, two reform bills were passed during the special session in the autumn—one sponsored by the government, the other a private member's bill. This year yet another bill came before the Diet (on 18 March), following a report by the Legislative Council of the Ministry of Justice.[1]

The series of reforms to the Commercial Code that began in the late 1990s can be seen as the result of concerns that Japan's traditional corporate system had ceased to function properly. The esteem that it had enjoyed in the 1980s, when Japanese money held sway and Japanese-style management was the object of universal admiration, faded when the boom of the late 1980s turned to bust in the 1990s. The series of scandals involving government departments and well-known companies, and the increasingly serious bad debt problem facing the country's banks showed some of the factors that had formerly been the object of admiration (e.g., the country's *dirigiste* industrial policies and its reliance on the banks to monitor and advise their corporate clients) in an altogether less favorable light.

The model that has come to be seen as an urgently needed replacement for Japan's traditional but now discredited corporate system is the US corporate system with its emphasis on share prices, shareholder value and the need to increase the value of a business. The strength of the US economy in the 1990s and the emergence of the concept of the "new economy" were seen as demonstrating the superiority of the US corporate system. In particular, it was the striking contrast between Japan, where more companies were disappearing than appearing and where little progress had been made

1 The text of the amendment and commentary on it can be found in the 25 March 2002 number of "Junkan Shoji Homu" [Commercial Law Review].

towards reforming the structure of industry by fostering the development of new businesses, and the United States, where venture businesses could be seen springing up in areas such as information technology and biotechnology, that aroused keen interest in the US corporate system.

It was as a result of this that one of the forces driving reform of the Commercial Code was the desire to adopt systems that existed in the United States but not in Japan and to abolish regulations that existed in Japan but not in the United States. The aim was to make the Japanese corporate system more similar, at least in some respects, to the US system.

The recent reforms can be broadly divided into four categories.

The first category is reforms designed to enable companies to have new legal tools for their financial strategies. The most important of these reforms were the gradual lifting and the eventual abolition of restrictions on treasury stock, and the adoption of a new system of trading lots to allow companies greater flexibility in determining the amount of money needed to invest in their shares. The second category is reforms (such as the adoption of share-for-share transactions and legislation for corporate separations) designed to make it easier for companies to reorganize. The third category is the adoption and greater use of equity incentive schemes such as stock options. These schemes can be considered an attempt to find a new use for shares, which had tended to be regarded in Japan simply as a means of either raising capital or protecting creditors *in extremis*. The final category is attempts to improve means of corporate governance in order, for example, to strengthen directors' monitoring powers (see Figure 1).

The first three can be considered, more generally, to involve the abolition of regulations in order to give management greater discretion while the last category can be considered attempts to tighten up regulations in order to prevent management from abusing this discretion.

Figure 1 Main Reforms of Japan's Commercial Code since 1990

	Increased range of choices for management and financial strategy	Changes to system of corporate governance
1990	Easing of restrictions on issue of preference shares Simplification of examination procedure for start-ups	
1993	Abolition of restrictions on size of corporate bond issues Abolition of fiduciary system for corporate bonds	Introduction of statutory auditors' committee and external statutory auditors Reduction in fee for instituting a class action by shareholders
1994	Easing of restrictions on share buybacks (where shares are purchased from earnings or for allocation to employees)	
1997	Easing of restrictions on share buybacks Simplification of merger procedure	Introduction of stiffer penalties for granting financial favors to shareholders
1998	Easing of restrictions on share buybacks (allowing shares to be purchased with capital reserves for a limited period)	
1999	Introduction of “share-for-share transactions” and “share transfers”	
2000	Adoption of legislation for corporate separations	
2001	Abolition of restrictions on treasury stock, introduction of new system of trading lots, introduction of equity call options, introduction of a wider range of share classes	Introduction of online voting in general shareholders' meetings Introduction of increased powers for statutory auditors Formalization of reduced powers for directors
2002 (expected)	Introduction of right of different classes of shareholder to elect or dismiss directors	Introduction of new system(s) of corporate governance based on committees and non-executive directors

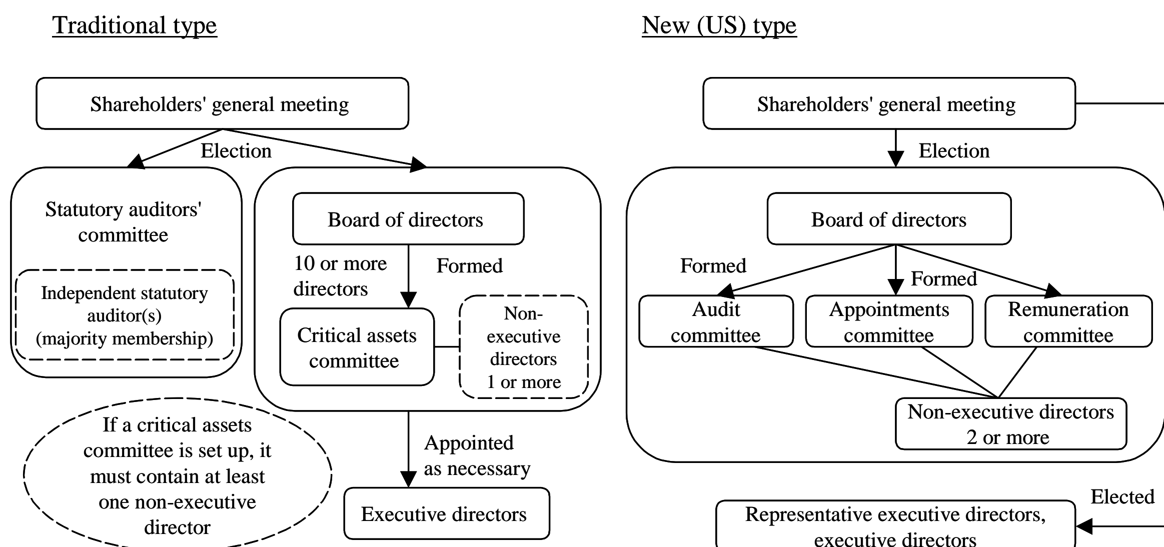
Note: Rather different in nature was the introduction of the minimum capital system in the 1990 amendment to the Code.
Source: NRI.

2. Governance System Advocated by the Reform Bills

These reforms to the system of corporate governance therefore have the potential to determine whether all these reforms to the Commercial Code will really enable Japanese companies to transform themselves. Unless management is able to use the wider range of strategic and financial options open to it to increase the value of the business, these options will be meaningless. Success will depend on whether corporate governance works properly and whether management can direct its ability and powers of discretion towards the goal of increasing the value of the business.

As Figure 1 shows, numerous reforms affecting corporate governance have already been made to the Commercial Code, including improving the systems for statutory auditors and actions by shareholders, and conducting general meetings of shareholders online. However, the most important reform is the one related to boards of directors that is incorporated in the reform bill currently before the Diet. In essence its aim is to allow companies to adopt a new system of corporate governance along US lines alongside the traditional Japanese system whereby statutory auditors monitor directors (see Figure 2).

Figure 2 Types of Corporate Governance Envisaged by the 2002 Amendment



Source: NRI.

In other words, for the first time, companies will be able to do the following.

As their main executive body companies will appoint executive officers and representative executive officers while existing boards of directors will become mainly responsible for overseeing these new executive bodies. However, statutory auditors, who have performed this function in the past, will no longer be appointed and will be replaced by a new audit committee.

The bill envisages that the main responsibility for overseeing management will lie with non-executive directors and that companies will set up three committees with at least three members each, the majority of whom will be non-executive directors. One of these (the "nominating committee") will be responsible for selecting potential directors; another (the "remuneration committee") will be responsible for deciding how much directors should be paid; and the third (the "audit committee") will be responsible for monitoring the company's operations. As non-executive directors will

be allowed to be members of different committees at the same time, companies will need to appoint at least three such directors.

The bill also stipulates that non-executive directors must not have been employed as directors, executive officers, managers or in any other capacity by either the company concerned or any of its subsidiaries or be currently employed in such capacity by any of its subsidiaries (Section 188.2.7.2 of the Commercial Code Reform Bill).

The term of office of directors appointed by companies that adopt this US type of corporate governance will be reduced from the current maximum of two years to one year.

However, even if a company decides to retain the current system of corporate governance, it will be able to set up a "critical assets committee" to give itself greater decision-making flexibility provided it has at least 10 directors and at least one non-executive director. This committee will have similar responsibilities to the ”operating committees” and “management committees” that already exist in many companies; but, unlike these unofficial bodies, its powers and responsibilities will be clearly defined in law.

As well as having these two options, companies can choose to retain the existing system whereby statutory auditors oversee the work of directors. In other words, the bill offers companies the choice of three different systems of corporate governance.

Incidentally, even if companies elect to retain the current system of governance, they are required under the amendment to the Commercial Code that took effect last autumn to increase the number of external statutory auditors within three years from the one auditor that is currently required to at least half of the total number of statutory

3. The Key to Reforming Corporate Governance

What the latest reforms to the Commercial Code therefore mean is that the system of corporate governance used by Japanese companies may undergo considerable change if many of them decide to adopt one of the new systems. In fact, quite a few companies have already changed their system of governance of their own accord in apparent anticipation of the reforms. These changes include increasing the number of

their non-executive directors, adopting a system of executive officers, and setting up nominating committees and remuneration committees.

However, such anticipatory action may also have negative effects. For example, although the aim of adopting a system of executive directors and reducing the number of directors is to speed up the decision-making process and separate the functions of running a company and overseeing how it is managed, in many companies the most senior member of the board of directors under the old system has simply been appointed as director under the new system. The result in such cases is that executive officers tend to be regarded simply as potential directors one rank above normal employees. Similarly, directors are often in charge of particular departments and in a position to issue instructions to executive officers, who end up being simply the top layer of management rather than the people whose job it is to oversee how a company is managed.

The relationship between the directors' job of overseeing how a company is managed and the executive officers' job of running the company should, ideally, not be the same as the rigid superior-inferior relationship between a baseball or soccer manager and his players, where the manager may issue instructions or substitute players even in the course of a match. Rather, it should be like that of the judges in a gymnastics competition, although, unlike real judges, they also act as coaches, both judging performance and offering advice on how it could be improved. Reforming the role of the board of directors without making a proper distinction between running a company and overseeing its management risks being seen by cynics as simply giving company officers the title of executive officer in order to reduce the number of officers who can be the subject of a class action by shareholders.

So where does that leave non-executive directors, who have recently been appointed in increasing numbers in Japan? It is often pointed out that one of the shortcomings of the traditional Japanese system of corporate governance is the fact that the internal controls on company chairmen and presidents are inadequate. Where a board of directors consists entirely of people who have worked their way up within the company under a system of employment for life and pay and promotion by seniority, it is difficult for internal controls on chairmen and presidents with the final say on appointments to work effectively as envisaged by the Commercial Code. Similarly, it would be unrealistic to expect statutory auditors to be able to oversee a company's management properly so long as these auditors are former directors or people who have been promoted directly from positions within the company—hence the interest in non-executive directors as people who are independent of a company's internal structure.

In fact, there have been cases in Japan where non-executive directors have been able to perform their role of overseeing management properly. In 1982, in a case that led to the president of Mitsukoshi Department Store being forced to resign in a company coup d'état and to criminal charges being made against him in a personal capacity, a senior figure in the Mitsui Group who had been appointed as a non-executive director of Mitsukoshi, Goro Koyama (now a senior adviser to Sumitomo Mitsui Banking Corporation), not only remonstrated directly with the president but supported those directors who sought to remove him.

However, there are some who vigorously oppose the idea that non-executive directors can perform the role expected of them properly. These people take the view that, even if outsiders are otherwise well qualified, they will have insufficient specialist knowledge of either the business in general or the company and, far from being in a position to prevent management excesses, are more likely to make bad management decisions.

Nor is there any doubt that in many companies that do have non-executive directors these directors are sidelined. Equally, there are many companies that do not have any non-executive directors but have still been highly successful as a result of a well-thought-out management strategy. Ultimately, if companies appoint as non-executive directors people who are simply either friends of the president or stakeholders, it will be nigh impossible to prevent them from colluding with senior management even if they are appointed according to the letter of the law. One example of this is Enron, where the majority of the board of directors were non-executive directors. Not only did they fail to control the activities of some members of the company's senior management, they were apparently not even aware that there was a problem.

What happened at Enron can be considered a major shortcoming of the US system of corporate governance, which has tended to be the object of universal admiration in Japan, and of the focus of management on the interests of shareholders. The awareness of this problem has occasioned a number of analyses in Europe and the United States.

Most notably it has been pointed out that one of the reasons why Enron's non-executive directors failed to perform their role properly is (in addition to the fact that they were perhaps not the best people for the job) the fact that they lacked a leader through whom they could exert pressure on management. In an article on this subject, the *Financial Times* listed some of the lessons that can be drawn about corporate governance from the Enron debacle (Figure 3).

Figure 3 Main Governance Reforms Advocated by Financial Times

- Governments and investors should emphasize need to reform the culture of the board of directors.
- Fully independent non-executive directors should be appointed with a clearly designated leader and better remuneration to ensure greater commitment. The balance with internal directors should be improved.
- The audit committee should be given greater powers and be allowed to negotiate with the external auditor, decide accounting procedures and deal with whistle-blowing.
- Expensive stock option schemes should be restricted and stricter limits placed on option exercise periods

Source: Financial Times, 19 February 2002.

Perhaps more important than the mere existence of non-executive directors is whether or not they are well chosen and well led. Contemporary reports about the role of non-executive directors in the downfall of the president of Mitsukoshi Department Store in 1982 (see above) suggest that even then many people believed that non-executive directors were in no position to tell a president to resign and that the incident says less about their effectiveness in general than about the strong leadership one outstanding individual was able to provide.[2]

No matter what the system is, if the management whose job it is to increase the value of a business are half-hearted about making the system work, it will be rather like a farmer who ploughs his field but forgets the seed. Ultimately it is the people who fill these various management roles who will determine whether or not management's message gets across.

4. The Need for a Change of Attitude and the Importance of Management's Message

If this means that the attitude of management and the choice of people for the job is more important than the particular system used, management will need not only to change its attitude of its own accord but also to have a clear idea in both theory and practice of how the choice of a particular system will enable it to increase the value of a business. In addition, it will need to foster its relations with investors to ensure that they understand its message.

2 Nihon Keizai Shimbun, 21 September 1982, p. 9 "Radar" column.

Whether, as a result of the current reforms to the Commercial Code, a company decides to adopt the US system of corporate governance or to revamp its existing Japanese system, the impact should be considerable if the choice matches its situation and the personality of its directors and executive directors. Companies therefore need to assess their situation properly and decide which system is best for them and what sort of person would be the best director or executive director to make it work.

The same is true of the various other systems that have been adopted as a result of the reforms to the Commercial Code.

One example of this is the lifting of restrictions on share buybacks. It would be simplistic to say that, just because this has increased the number of options open to CFOs, a company that buys back its shares is therefore a good company. While, other things being equal, this will enhance a company's key financial ratios (e.g., earnings per share and return on equity), it may also be taken as an indication that the company has nothing better to spend its shareholders' equity on. Therefore, if a company does decide to go down this path, it should not be simply because other companies have done so. It needs to have a clear reason and to convey this convincingly to investors.

The same is true of management incentives such as stock options. Whereas only their benefits used to be considered, companies with expensive stock option schemes are now widely criticized for elitism, and doubts are being cast on whether they really secure a commitment from staff that produces better sales and earnings in the medium to long term. There is also growing concern that the equity dilution they cause may create a conflict of interest with existing shareholders. There is therefore more need than ever for companies that do decide to adopt such schemes to explain the reason and what they expect to achieve.

Reform of the Commercial Code is to be warmly welcomed inasmuch as it has given companies more freedom of choice—whether it be by ending restrictions on activities that used to be prohibited or by allowing the use of new systems. However, companies eager to exercise this freedom should not forget that they have a duty to investors to explain the reasons for their choices and what they hope to achieve.

In this connection, it needs to be emphasized that communicating with investors should not be allowed to become a mere formality.

Enron had a good record on disclosure and investor relations, and had a good reputation with institutions and analysts. Its problem was not that it did not have an

investor relations policy but that the information it was disseminating to investors was false while important information was not disclosed.

One of the results of the Enron debacle is that investors in US capital markets have become increasingly suspicious of all the information that US companies disseminate. There is also a debate going on about how to overhaul US accounting standards and disclosure requirements. Japanese companies should learn a lesson from US experience and go back to the basics of investor relations and be more positive about disclosing information—even if the information itself is not always positive—in order to paint a true picture and gain investors' understanding.

What companies need to do as they enjoy ever greater freedom of choice is not to concern themselves with the technicalities of devising new systems (or "ploughing the field") but to concentrate on how they can sow a field that has already been ploughed in order to reform their systems of corporate governance.