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Corporate Governance in Japan

From the Viewpoints of Management, Accounting, and the Market

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Springer

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Foreword

In Japan, the problem of corporate governance has been cogently argued in the field of social science for the past decade, and the issue has also been taken up separately in law, business administration, and accounting. This book, however, is the first to take a general overview of corporate governance with respect to management, risk management, accounting, and the capital markets.

Corporate governance in the broad sense must include stakeholders with various interests while taking into consideration the sometimes unscrupulous affairs of companies and bankruptcies of big businesses, along with today's increasing numbers of mergers and acquisitions. Both the company manager and the institutional investor have begun to be more concerned about corporate social responsibility (CSR) and socially responsible investment.

After 2003, the issue of CSR began to be taken up more frequently by the media in Japan, and study meetings and committees associated with the Ministry of Economy, Trade and Industry, Ministry of the Environment, and the Ministry of Health, Labour and Welfare were established. These trends are evidence of significant changes in Japanese corporate governance. The study presented here proposes that a company should play a social role to bring about a sustainable society.

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Preface

In 2002, we began our international comparative study of corporate governance, setting out to study the multidimensional aspects of corporate governance: the institutional investor, the board of directors, compliance, moral hazards, observance of an accountability contract, stock options, and corporate information disclosure. This book is the result of that 3-year-long study.

Recently, corporate governance in the broad sense, including corporate social responsibility (CSR) in particular, has attracted attention. Incidents in which Japanese companies have been disgraced have occurred one after another. Meanwhile, hostile buyouts are becoming a reality in Japan. One might reasonably wonder: Is stockholder value creation the one and only aim of corporate activity?

Management itself became a topic of consideration following the cases of Enron and WorldCom in 2001. The belief that a manager should not simply create profit to be able to hold it for stockholders began to acquire some currency.

In an environment in which recognition of CSR is being reawakened, risk management of a company has become more important to managers. A study of reform in corporate governance and an approach to the accounting system, with concrete disclosure of managerial rewards, have been based on a critical view of whether the accounting system supports such reform. From the viewpoint of risk management, we examined errors of "goodwill" in management judgment as an element of corporate governance, viewing them as judgmental hazards as well as moral hazards faced by a manager in a complex environment.

This book is divided into three parts. In Part 1, we discuss corporate governance from four approaches: management, moral hazards, accounting, and capital markets. Chapter 1 is a general approach to management. In Chapter 2, we examine moral hazards and the problem of corporate governance. Chapter 3 deals with accounting and corporate governance. In Chapter 4, we discuss corporate governance from the viewpoint of the institutional investor.

Part 2 examines the trend in corporate governance in Japan of recent years in several areas. In Chapter 5, we clarify the situation regarding the exercise of voting rights by Japanese institutional investors. In Chapter 6, we focus on the structure of the Japanese board of directors. Disclosure of rewards is an integral

part of corporate governance, and, as discussed in Chapter 7, the movement from disclosure to expense recognition in accounting is part of corporate governance, especially with regard to stocks and related rewards such as stock options. With Chapter 8, we take the Japanese automobile insurance industry as a concrete example from the viewpoint of management judgment and risk management. We examine an ideal method of corporate governance of an individual company by management judgment over a low-cost strategy in that automobile insurance market.

In Part 3, we consider the issue of corporate governance in situations of global economic development. With Chapter 9, we clarify the influence that the "stockholder first" principle of institutional investors (in the United States in particular) has had on the Japanese financial system and on corporate governance. In Chapter 10, we examine the OECD Principles of Corporate Governance, revised in 2004, which has become an international standard of corporate governance and has exerted considerable influence in Japan.

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Mariko Nakabayashi
Yoko Nakoshi

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Part I
Four Approaches to Corporate Governance

1
Management and Corporate Governance

Nobuyuki Demise

1. Introduction

This chapter is intended as an exploration of the historical formation between the management and corporate governance relationship. The first section describes the process of separation of ownership and management. In modern corporations, the management is separated from the ownership, creating a need for professional managers. The second section describes the nature of professional managers, and how they may change the purpose of the corporation. According to Jensen, at the heart of the corporate governance debate there is a stark division of opinion about the fundamental purpose of the corporation.[1] The third section discusses the issues of the purpose of the corporation, and is related to corporate social responsibility. The last section presents the characteristics of business ethics and corporate social responsibility in Japan.

2. Separation of Ownership and Management

The founder took part in the management of his company at first. In due time, his company was listed on the stock exchange and the founder decreased his holdings relatively. Later his company grew and formed a "company group." After many years, he and his family left the post of his company. At the beginning of the 20th century, there were four gigantic financial combines, or *zaibatsu*, Mitsui, Mitsubishi, Sumitomo, and Yasuda. At the center of every zaibatsu was the holding company. Zaibatsu families controlled the holding companies and were the directors of the main companies. However, after World War II GHQ (the General Headquarters of the Allied Powers) broke up the Japanese zaibatsu and compelled zaibatsu families to dispose of all company shares. GHQ directed the Japanese government to prohibit holding companies and ordered many

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[1] See Jensen (2001).

Japanese managers who had cooperated with the Japanese military authorities to leave public life. Thus, the founder and his family left the post of many Japanese companies that were founded before 1945.

After World War II many companies, including Honda Motors, Sony, and Sanyo Electric, were established. In most of these the founder wanted his family to succeed to his post. However, Soichiro Honda, the founder of Honda Motors, did not want his son to succeed him and did not allow him to enter Honda Motors. He explained that after a company is listed it becomes a public institution. The performance of a company is influenced by the business environment. Business situations change constantly and are affected by serious aspects such as economic turbulence. In such environments, top management needs to respond to change the ability, experience, and knowledge of business administration. Although they were family, Honda believed that his son did not have enough ability, experience, and knowledge and was thus not suited for top management.

When business scandals arise or company business performance is bad for several years, founder families often leave the posts of their company. An example of this came about recently due to false reporting of share ownership: Yoshiaki Tutumi, the chairman of Kokudo, left his post at Kokudo, which was practically the holding company of the Seibu group. It can take a long time for founder families to leave their company posts. In 2005, the top management of Sanyo Electric changed. Members of the founding families remained in positions of power, but a former outside director was appointed chief executive officer (CEO).

In the 1980s, many major Japanese national enterprises were privatized, including Japan National Railway, the Nippon Telegraph and Telephone Public Corporation, and the monopolistic Japan Tobacco enterprise. At first they were changed to companies with limited liability, whose shares were owned solely by the Ministry of Finance, but later, many of them were listed. The top management was in charge of full-time managers, who were not public servants. Thus in the privatized companies the separation of ownership and management evolved.

In the Toyota Motor Corporation, Toyoda families were in charge of top management. Toyota was first established in 1937 as a spin-off from Toyoda Automatic Loom Works, one of the world's leading manufacturers of weaving machinery.[2] Now, after roughly 70 years and immense company changes, the Toyoda families are no longer large shareholders. While Akio Toyoda is the vice president of Toyota and Shoichiro Toyoda is the honorary president, other members of top management and board members are not from Toyoda families, including the chairman and president. It is still said that the Toyoda families are a symbol of Toyota Motors, that members of the Toyoda family had excellent management ability and experience, and that they embodied Toyota corporate culture.

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[2] See http://www.toyota.co.jp/en/about_toyota/history/index.html

3. Professional Managers

Many directors and executives in Japanese companies are former employees of those companies. Most of them went to work in the company after graduation. They were promoted to the position of executive in the same company, or other companies that belonged to the same company group, for about thirty years. As they followed their business career in the same company, they observed the customs in their business and embodied its corporate culture. This is one of the reasons why it is said that employees are key stakeholders in Japanese companies. Some directors feel they represent employees in their company, rather than their shareholders. Thus, the majority of the board members are in-house directors who also hold executive posts.

When many large companies collaboratively hold shares in other large companies it is known as cross-shareholding, considered a preventive measure for a takeover bid (TOB). Top management would not be exposed to the menace of hostile takeover and yielded relatively large power over company assets. Banks would finance many companies that belonged to the same company group, creating dependency on the banks. Consequently, when the companies faced crises, the banks would send executives to help reconstruct the company. Recently however, the practice of cross-shareholding is decreasing, causing more Japanese companies to be vulnerable to TOB.

In 2005, Livedoor, a famous IT company in Japan, acquired about 30% of Nippon Broadcasting System, shares in one night. Nippon Broadcasting System belonged to Fuji-Sankei group and held many shares in Fuji Television and Pony Canyon, which belonged to the same company group. It was thus believed that Livedoor was aiming to acquire shares of Fuji Television at a lower cost. M&A Consulting, a famous investment fund in Japan, pointed out that the ownership structure in the Fuji-Sankei group was already warped. Later, Fuji Television began takeover bids for shares of Nippon Broadcasting System. In the end, Fuji Television bought all the shares of Nippon Broadcasting System that Livedoor held, and entered into an alliance with Livedoor.

Subsequently, the president of Nippon Broadcasting System left his post and the chairman of Fuji Television kept his post. At that point, Nippon Broadcasting System was essentially a subsidiary company of Fuji Television. Later, Nippon Broadcasting actually did become their subsidiary. In subsidiary companies, top management has less discretion than that of the parent company. Some executives and directors in Japanese companies have less experience compared with the president or top management of their subsidiary companies. Some of them have had experience as the head of their department. There, they learn the practice of top management. In Japan, it is only recently that business schools have included a curriculum for business leader education.

Figure 1 shows the relationship between an owner and a manager in a corporation. The owner is compared with a lord, a beneficiary, and a principal. On the other hand, the manager is compared with a steward, a fiduciary, and an agent. The manager resembles a steward, because he/she is under stewardship and is

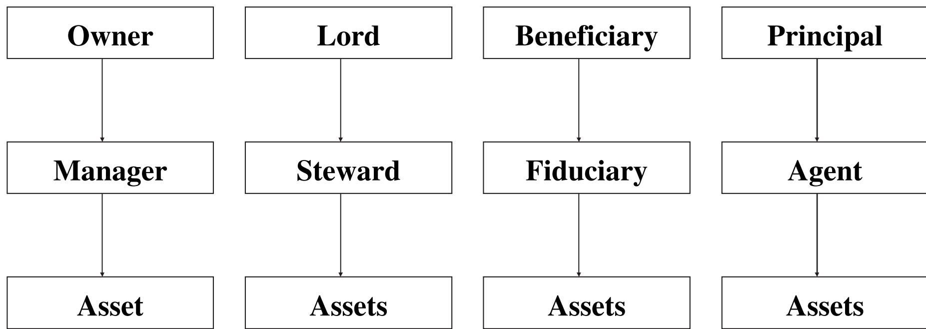

Fig. 1. The relationship between owner and manager

accountable to the owner, or the lord. Unless the manager discharges stewardship and accountability, he/she will be removed from the position. The owner, or in modern-day business the assembly of shareholders, has not only power to decide but also the ability to judge the management. However, in actuality all owners/shareholders have the authority to judge the management. They rarely remove directors in a general meeting of a company. In Japan, though it is only recently that the word "accountability" has begun to be used more often, accountability is at the heart of reforming corporate governance.

The manager resembles a fiduciary, because they are under fiduciary duty to the owner or the beneficiary. The manager is supposed to manage company assets in the interest of the owner, which means each shareholder. That is his/her fiduciary duty. On the other hand, the owner is supposed to have neither the ability nor desire to manage a company. Therefore the managerial ethics, or in other words, professional ethics, need to be part of his/her nature. If one of the managers is involved in an unfair practice within their business, he/she will lose their reputation. Later, he/she will leave their post voluntarily. In Japan, after the exposure of malpractice the president or CEO would be obliged to apologize to the world (*seken*), because malpractice damages the reputation of the company.

The manager resembles an agent, because he/she is under contract by the owner or the principal to manage the assets of a company. The agency theory that Fama applies to the firm shows some features of this relationship.[3] In the agency theory the manager or the agent is presumed to pursue his/her own interest. The owner or the principal is presumed to pursue his/her own interest as well. The agent takes opportunistic actions such as adverse selection and moral hazard, because there is an informational asymmetry between the principal and the agent in the theory.

The central problem of the agency theory is monitoring. The board of directors, the stock market, and the market for corporate control are important for

[3] See Fama (1980).

the monitoring mechanism. The board of directors is in charge of the internal control and the screening for top managers, or executive officers. In the agency theory, directors discharge their duties, because each director is evaluated in the market for candidates of directors. The lower the stock price, the easier it is for outsiders to take over the company. It is the manager's duty to consider the price of stock to prevent outside takeover.

Many directors are selected from among executive officers who belong to the same company in Japan. In this way cross-shareholdings prevent hostile takeovers. As a result, some managers are involved in unfair practice within their business. This has led some to believe that the monitoring mechanism in Japan needs to be strengthened. One step toward this is the revision of Japanese Company Laws that took place in 2005, and requires that Japanese companies conduct an internal control. In these instances, many top managers discharge their duties to manage company assets and improve the performance of the company. What seems to be lacking is a concrete set of guidelines and purpose for the corporation rather than a monitoring mechanism.

4. Purpose of Corporation

Who controls a corporation? This is the critical question for Japanese scholars who study business administration, especially those who specialize in corporate systems. Considerable numbers of studies have been conducted on corporate control since Berle and Means published *The Modern Corporation and Private Property* in 1932. Many scholars examined the structure of ownership in large Japanese companies and debated that issue. The controversy regarding corporate control is similar to the controversy about corporate governance, because there is a focus on the relationship between the owner and the manager, the structure of ownership, and the managerial leadership.

The central problem of corporate governance, however, is the purpose of a corporation. It is often said that the purpose of a corporation is maximizing shareholder value. As Jensen wrote, value maximization tells the participants in an organization how they will assess their success in achieving a vision or implementing a strategy.[4] This is only one point of view regarding the purpose of a corporation. Monks and Minow, who are famous for corporate governance study, point out that the purposes of corporations are human satisfaction, creating social structure, beneficial efficiency and efficacy, ubiquity and flexibility, and identity.[5] According to their view, maximizing shareholder value is related to human satisfaction and beneficial efficiency and efficacy.

In Japan, the term "shareholder value" is often used in disputes over corporate governance. The mid-1990s witnessed the spread of shareholder values in Japanese business society, because the structure of ownership changed radically.

[4] See Jensen (2001).
[5] See Monks and Minow (2004), pp 14–16.

On the other hand, it is said that top management in Japanese companies believe that employment is important. It is important for Japanese managers to maintain and further develop their company, because they think that companies serve as a community. Japanese companies are often called "the community firm."[6]

Recently the term "stakeholder" has been increasingly used in Japanese business society. Many specialists in business administration have used this term since the 1980s. However, many scholars originally mistook stakeholders for interest groups or constituencies. Japanese scholars recognize that the term "stakeholder" refers to persons and groups that are affected by an organization's decisions, policies, and operations.[7] Post, Preston and Sachs define "stakeholders" as follows[8]:

> The stakeholders in a corporation are the individuals and constituencies that contribute, either voluntarily or involuntarily, to its wealth-creating capacity and activities, and that are therefore its potential beneficiaries and/or risk bearers.

They suggest that both shareholders and stakeholders are risk bearers. Some scholars extend the concept of organizational wealth. The purpose of corporations is to create organizational wealth. According to Post, Preston, and Sachs, organizational wealth is the final measure of the capacity of an organization to create benefits for any and all of its stakeholders over the long term.[9]

To make a profit is one of the purposes of a corporation, but it is not the exclusive purpose. Many corporations make a profit from a business activity but suffer a loss. Profit is one of the results of business activity. Business activity produces goods and services that consumers or society needs. Business is related to not only the market but also society. Representative companies in Japan, such as Matsushita Electric, Toyota Motors, and Honda Motors hold these ideals. Konosuke Matsushita, founder of Matsushita Electric, formulated Matsushita's Basic Management Objectives in 1929 as follows[10]: "Recognizing our responsibilities as industrialists, we will devote ourselves to the progress and development of society and the well-being of people through our business activities, thereby enhancing the quality of life throughout the world." Matsushita recognized his business activities were related to the progress and development of society in the early 20th century. Presently the constituencies of Matsushita Electric understand his ideas and put Matsushita's Basic Management Objectives into practice.

Toyota Motors also has guiding principles[11]:

1. Honor the language and spirit of the law of every nation and undertake open and fair corporate activities to be a good corporate citizen of the world.
2. Respect the culture and customs of every nation and contribute to economic and social development through corporate activities in the communities.

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[6] See Inagami and Whittaker (2005).
[7] See Lawrence et al. (2005), p. 7.
[8] See Post et al. (2002), p. 19.
[9] See Post et al. (2002), p. 45.
[10] See http://panasonic.co.jp/company/en/gp_0001.html
[11] See http://www.toyota.co.jp/en/about_toyota/message/index.html

3. Dedicate ourselves to providing clean and safe products and to enhancing the quality of life everywhere through all our activities.
4. Create and develop advanced technologies and provide outstanding products and services that fulfill the needs of customers worldwide.
5. Foster a corporate culture that enhances individual creativity and teamwork value, while honoring mutual trust and respect between labor and management.
6. Pursue growth in harmony with the global community through innovative management.
7. Work with business partners in research and creation to achieve stable, long-term growth and mutual benefits, while keeping ourselves open to new partnerships.

The word "good corporate citizen" is used in the principles. The long-term growth and mutuality are emphasized in the principles. Recently Toyota Motors is operating around the world and the constituencies of Toyota Motors are required to act in accordance with the principles.

Corporate governance is related to the philosophy in Honda Motors. Corporate auditors monitor their operations from the point of view of their philosophy. The following is the Honda Philosophy[12].

Basic Principles
  Respect for the Individual
  The Three Joys (the joy of buying, the joy of selling, the joy of creating)
Company Principle
  Maintaining a global viewpoint, we are dedicated to supplying products of the highest quality yet at a reasonable price for worldwide customer satisfaction
Management Policies
  Proceed always with ambition and youthfulness;
  Respect sound theory, develop fresh ideas, and make the most effective use of time;
  Enjoy your work, and encourage open communication;
  Strive constantly for a harmonious flow of work;
  Be ever mindful of the value of research and endeavor.

Honda Motors operates around the world. The constituencies of Honda Motors in the world recognize their philosophy and their values. Honda Motors regards the "three joys" as important. Honda also regards human satisfaction as one of the purposes of the company.

The purpose of corporations is related to not only economic value but also social values. Therefore there is an intimate relationship between the problem of corporate governance and corporate social responsibility (CSR).

[12] See http://world.honda.com/profile/philosophy/

5. CSR and Business Ethics

In 1956, the Japanese Association of Corporate Executives, Keizai Doyukai, issued a statement on social responsibility for corporate executives. They suggested that the corporation was a public institution and that corporate executives were no longer stewards of shareholders, but that they were stewards of the society in which their companies operated. The goal of social responsibility for corporate executives was to develop the economy in harmony with society. In fact, Japan's GNP had become second in size only to the United States by 1968. On the other hand, the price of this rapid economic growth was steady pollution. In those days, the different concepts of CSR were introduced into Japan from the United States. Some of these were related to interaction between business and society. One concept suggested by Friedman was that the only social responsibility of corporate executives was to make as much money as possible.[13] In the early 1970s, the members of the Japan Society of Business Administration entered into a controversy regarding CSR in their national conference. However, the oil crisis brought about economic business depression. The more business focused on economic recovery, the less it was interested in CSR.

In the mid-1980s, many Japanese companies went into the United States after the high-yen recession and the trade friction. The community in which Japanese companies operated urged them to undertake philanthropic activities. At first they started with donations and volunteer activity, after which many large companies introduced philanthropic activities into Japan. This was related to the "bubble economy."

After the collapse of the "bubble economy," many company scandals were brought to light. Large security companies were forced to compensate for losses their customers had suffered due to heavy falls in stock prices. The Japan Business Federation, Nippon Keidanren, published the Charter of Corporate Behavior in 1991. After that, many large companies in Japan established a code of ethical conduct. Some large companies gave large sums of money to *sokaiya*, who are professional troublemakers at stockholders' meetings, unfairly. Japanese scholars began to use the term "business ethics" to introduce and describe the situation in the United States. The Japan Society for Business Ethics Study was established in 1993. Some top managers regarded business ethics as important and were willing to institutionalize business ethics on their own initiative, but there was not a growing tendency for Japanese companies to do so, because many of them gave top priority to improving efficiency within the company. After the collapse of the "bubble economy," many companies suffered large slumps and some went bankrupt. Some top managers believed in *zhukyou*, the Confucian ethic that strengthens the concept of belonging to a (their) company, and did not regard business ethics as important.

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[13] See Friedman (1972).

In 2000, a large food company sold milk that poisoned some 15,000 people. A large motor company car defect cover-up was exposed. In 2002, another food company re-labeled imported beef as domestic beef and committed malfeasance, obtaining money from the government by fraud. In a large trading company, a manager was arrested for bribery. It was found that Tokyo Electric Power Company managed for years to cover up defects in nuclear power plants. Some cases were detected by the authorities, which received their information from whistle-blowers from inside the company. Whistle blowing, however, conflicts with Confucian ethics, which hold that matters should be resolved from within, strengthening the feeling of belonging to the company.

The Japanese Financial Services Agency published an inspection manual for banks in 1999. The word "compliance" was used therein. R-BEC, the Business Ethics and Compliance Research Center at Reitaku University, published ECS 2000, an Ethics Compliance Management System Standard, in 1999. In ECS 2000, business ethics, legal compliance, and ethical–legal compliance are defined as follows[14]:

Business ethics are defined in practice as including all activities carried out within an organization in order to ensure fair and responsible behavior of the organization.

Legal compliance is defined here as all the internal activities of an organization made in order to comply with the laws and regulations applicable to their business and to the goods and services in which they deal. Ethical–legal compliance is defined here as the compliance with applicable laws and regulations (including social values) and all internal activities made in order to implement the ethical standards that an organization has established upon its own volition.

In Japan, many people do not make a distinction between "business ethics" and "compliance," but each term is separately defined in ECS 2000. R-BEC publishes ECS 2000 to put it to practical use. Some companies have adopted methods of ECS 2000, GRI, and UNGC, as well as introducing ethics codes, ethics committees, ethics communication systems, ethics officers, and ethics training programs. Furthermore, many companies in Japan have also formulated environmental policy. These companies, taking the issue of the environment seriously, also publish an environmental report. Recently more companies have published these environmental and social reports, as well as a "sustainable report," which contains information on the social performance evaluated by the companies.

In 2003, Keizai Doyukai published The 15th Corporate White Paper on "Market Evolution and CSR Management: Toward Building Integrity and Creating Stakeholder Value."[15] Keizai Doyukai regards corporate social responsibility and corporate governance as most important when companies build trust and

[14] See http://r-bec.reitaku-u.ac.jp/files/ECS2000E.pdf
[15] See http://www.doyukai.or.jp/en/policyproposals/articles/pdf/030326_1.pdf

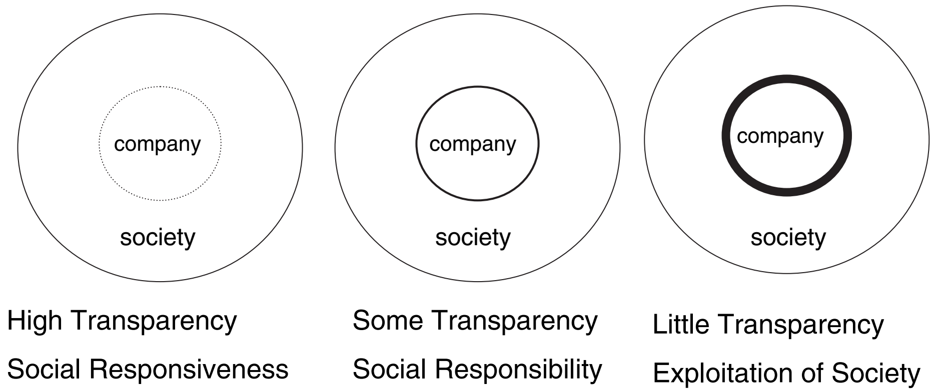

Fig. 2. Three models of a Japanese company

create sustainable stakeholder value. In 2004, Keizai Doyukai published the results of a survey on corporate social responsibility and corporate governance in Japan.[16] It concluded that Japanese companies needed to build compliance systems with effective checking mechanisms.

In 2004, Nippon Keidanren revised their Charter of Corporate Behavior.[17] Nippon Keidanren recognized that their stakeholders became more interested in corporate social responsibility and they emphasized human rights, communication with their stakeholders, and supply chain. Both Keizai Doyukai and Nippon Keidanren are composed of top managers and corporate executives. In each company, it is necessary for top managers to commit to their stakeholders and to institutionalize business ethics, or to ensure corporate social responsibility. However, not all of the top managers in large Japanese companies recognize or embrace social responsibility to the same degree, largely due to the fact that many do not understand the society in which their companies operate or that their stakeholders are continuously changing their relationship with the company. Many of these companies are relatively cut off from society, resulting in a sort of exclusivity.

Figure 2 shows the relationship between companies and society in Japan. The companies with high transparency are responsive to the expectations of stakeholders, even if they are small. They ensure a positive corporate social responsibility. The company with some transparency responds to large requests from stakeholders. Large requests, for example, are the needs of customers or claims of large shareholders. The company with little transparency exploits stakeholders for its own ends.

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[16] See http://www.doyukai.or.jp/en/policyproposals/articles/pdf/040116.pdf
[17] See http://www.keidanren.or.jp/english/speech/spe001/s01001/s01a.html

6. Conclusion

In Japan, the top managers play a role in reforming corporate governance, related to the relationship between the ownership and the management. The relationship is largely influenced by historical factors, including the Japanese zaibatsu structure and relationships between founder families and corporations. In modern corporations, the management is separated from the ownership and the need for professional managers is created. Some of these managers recognize that they are not only stewards for the owners but also stewards for society. When they are managing the corporation they ensure corporate social responsibility. The company with high transparency is responsive to expectations of stakeholders and is continuously reforming corporate governance.

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2
Moral Hazard in Corporate Governance

Mariko Nakabayashi

1. Introduction

The usage of the concept of moral hazard has diversified since it has been increasingly used outside the insurance industry. For example, instead of describing the behavior of the insured, the term moral hazard has been used to describe the unethical decision making of managers, which can lead to scandals and criminal behavior.[1]

This chapter aims to contribute to the study on moral hazard in agency relationships, specifically concerning managerial decision making. Moral hazard implies an inefficiency factor, and it is essential to cope with it in agency relationships. In addition to mandated prevention methods such as laws, an ethical viewpoint is necessary to effectively cope with the moral hazard problem. The study of ethical behavior and risk management in the insurance industry will contribute to a better understanding of moral hazard in general and will lead to more effective methods of ethics-related risk control in all types of firms and institutions.

2. Moral Hazard in an Agency Relationship

2.1 The Key Points of Moral Hazard

Moral hazard refers to the trait of dishonesty or character defects in an individual that increase the frequency or severity of loss.[2] It is part of all human behav-

[1] From August 2002 to August 2005, the most widely read Japanese financial newspaper (*Nihon Keizai Shinbun*) published 269 articles that included the term moral hazard. All the articles pertain to the ethical aspect of managerial decision making. Meanwhile, the articles on insurance crime do not include the term at all. Many insurance crimes were exposed during this period; however, this term is not included in the articles pertaining to insurance crime. The relationship between insurance crime and moral hazard was not generally acknowledged. However, by 1998, usage of the term moral hazard in the managerial context became one of the major fads in the most authoritative copywriting contest and it is now a commonly used word in the Japanese language.
[2] Rejda (2005).

ior. Although the term "moral hazard" originated in the insurance industry, it is also used outside that industry. Moral hazard may occur in all agency relationships.

Managers play a crucial role in firms. Moral hazard in managerial decision making implies violations of managers' obligations and can lead to negative results. Many corporate scandals have been exposed on a global scale and have caused huge losses to firms. Most of them were caused by managers' moral hazards.

2.2 *Moral Hazard in an Agency Relationship*

The term "agency relationship" has come to be used in economics to refer to those situations in which one individual (the agent) acts on behalf of another (the principal) and is supposed to advance the principal's goals. A moral hazard problem arises when the agent and principal have contrasting individual objectives, and the principal cannot easily determine whether the agent's reports and actions are being executed in pursuit of the principal's goals or are a part of self-interested misbehavior.[3] Thus, moral hazard is an inefficiency factor, and it is essential to cope with it in an agency relationship.

The moral hazard problem is a particular issue in the insurance industry. In this case, it refers to the tendency of the insured individuals to make inflated or fraudulent claims against the insurance company. The insurance company must cope with this tendency because the extra benefit enjoyed by the insured on account of this dishonest behavior results in significant financial losses, and eventually, the insurance becomes unavailable. The insurance company should regard the moral hazard problem as one of the most urgent issues to be tackled.

In general, moral hazard is considered to be a form of post-contractual opportunism that arises because actions that have efficient consequences are not freely observable. Hence, the person executing them may choose to pursue his or her private interests at the expense of others.[4]

2.3 *The Threat of Moral Hazards to Agency Relationships*

2.3.1 Insurance Market

The insurance contract is a risk-sharing arrangement, in which both parties have reciprocal obligations. According to insurance contract law, the insurer is regarded as an agent of the insured (Fig. 1).

Further, in order to make a contract, the insured is required to act in the interests of the insurer. Therefore, the insured also functions as an agent of the insurer

[3] Milgrom and Roberts (1992).
[4] Milgrom and Roberts (1992).

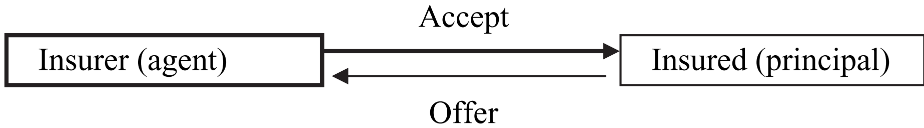

FIG. 1. Agency relationship in an insurance contract

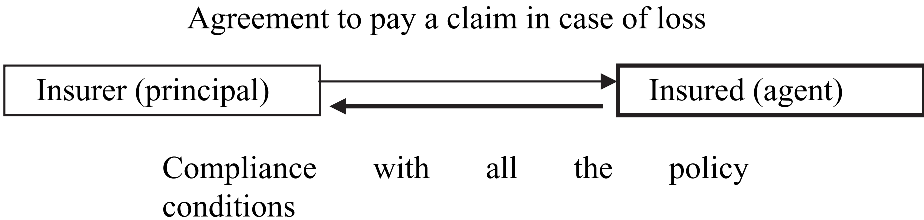

FIG. 2. Obligations to be considered when making an insurance contract

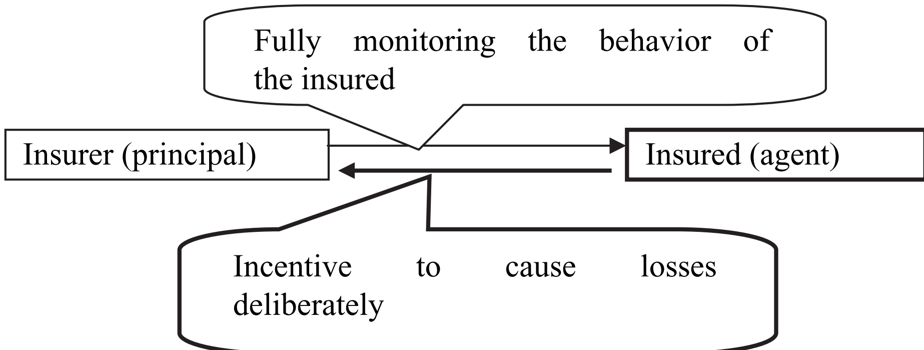

FIG. 3. The insured as an agent of the insurer: in theory

(Fig. 2). Ethical behavior is fundamental to this relationship, and moral hazards of the insured render this relationship fragile.

The insurance contract also functions as an aleatory contract. Depending on chance, one party may receive a value out of proportion to the value that is given.[5] Therefore, the insurance system itself offers an incentive for the insured (the agent) to deliberately cause losses with the intention of collecting insurance. Theoretically, in the insurance industry, the insurer, as the principal, is assumed to be capable of fully monitoring the behavior of the agent or the insured (Fig. 3). However, in reality, it is impossible for the insurer to do so, and as a result, the

[5] Redja (2005).

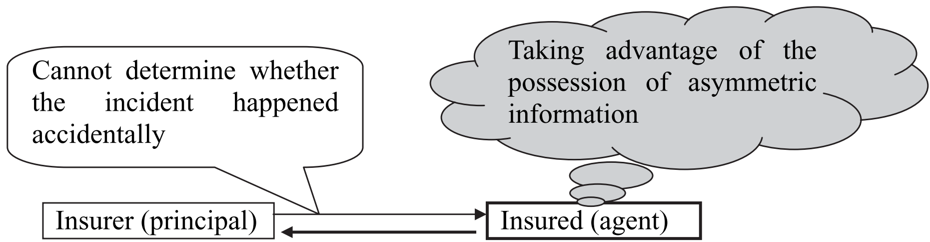

Fig. 4. The insured as an agent of the insurer: in reality

insured possess more relevant information or greater control over the outcome than the insurer.[6] As shown in Fig. 4, the insurer is unable to distinguish whether the incident occurred accidentally because the insured may have taken advantage of the possession of asymmetric information. The difficulty or the cost involved in monitoring and enforcing appropriate behavior creates the moral hazard problem. Therefore, there exist many cases where the insured can collect payment despite the incidents being intentionally caused. Insurance companies often pay for too many losses, and eventually the insured becomes uninsurable.

2.3.2 Management

Instead of describing the behavior of the insured, the term moral hazard has been used to describe the unethical decision making of managers, which can lead to scandals and criminal behavior.

Improper decision making by the manager is a moral hazard that can cause huge financial losses, and as a result, undermine the financial stability of the firm. The manager makes decisions as an agent of the stakeholders. Stakeholders are those people and groups that affect or can be affected by an organization's decisions, policies, and operations.[7]

There exist many agent–principal relationships in firms; every stakeholder has a unique stake in the firm, specifically in the corporation, in the position of ownership, and the managers should give priority to the stockholders.[8] On the other hand, there have been many views on the priority of the stakeholders in a corporation. Gilbert and Freeman (1988) maintain that corporations should be managed for the benefit of all stakeholders, not merely the stockholder. Accord-

[6] Rothschild and Stiglitz (1976).
[7] Post et al. (2002).
[8] The situation in which several risk-neutral principals simultaneously and independently attempt to influence a common agent; in the aggregate, always efficient and noncooperative behavior induces an efficient action choice if, and only if, collusion among the principals would implement the first-best action at the first-best level of cost (Bernheim and Whinston 1986).

ing to Goodpaster (1991), businesses have fiduciary obligations only to stockholders; however, they also have nonfiduciary moral obligations to those affected by their actions.[9] Therefore, the managers need to recognize all the stakes in their firm and deal with them accordingly. However, the decisions of the managers do not always contribute to the interest of every principal.

For example, since the late 1990s several scandals and criminal behavior involving Japanese firms have been exposed and have caused huge losses. They were caused and/or increased due to moral hazard. The managers made decisions that served their personal interests. In other words, they failed to play an appropriate role as agents of the stakeholders.

Japanese financial institutions have incurred huge debts because of their policy to provide indiscriminate loans during the alleged "bubble economy."[10] Although the managers made indiscriminate loans, most of them did not realize their moral hazard at that time. In order to compensate for their bad loans, the Japanese Government decided to provide financial assistance to the financial institutions in 1998. Since 1998, they have repeatedly pumped money into financial institutions. As a result, Japanese taxpayers have had to bear the brunt of the mistakes of careless managers. However, these managers have not been held responsible for their failures. In this situation, in the absence of individual responsibility, these managers have had no incentive to reform their behavior. Thus, this involves another type of moral hazard.

3. Effect of Ethics-Related Risk Control

3.1 Methods to Cope with Moral Hazard in Insurance Companies

The basic constructions of insurance contracts are ruled by the laws and the policy conditions that stipulate each contract in detail. The insurer's obligation to pay a claim depends on whether the insured has complied with all the policy conditions. In other words, the insurance contracts include systems to reduce asymmetric information among the parties and to prevent self-interested behav-

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[9] Competitors, wholesalers/retailers, employees (union), customers, governments, NGO/NPOs, and media have a nonfiduciary moral obligation to the managers in the corporation.

[10] The Japanese Bank Association reported that outstanding nonperforming loans of nationwide commercial banks fell to ¥28.33 trillion as of March 31, 2003. This was the first time since 1998 that bad loans fell to less than ¥30 trillion. It accounted for less than 70% of their largest bad loans at the end of March 2003 (*Nihon Keizai Shinbun*, December 27, 2003). In August 2005, the Bank of Japan says in its research paper titled "Financial System Report—Focusing on the Banking System," "After more than a decade of struggle, Japan's financial system has almost overcome the unperforming-loan problem and has entered a new phase of development."

ior of the insured.[11] However, the effects of these systems are limited because the insured can participate in and leave the insurance market at will.[12] There does not exist a cost-effective method for the insurer to observe the precautions taken by the insured. Therefore, implementation of the monitoring system is often impossible or extremely expensive.[13]

As noted above, the insurance company cannot prevent moral hazard completely. For example, in Japan, most insurance companies have tended to respond to the moral hazard problem with their method of cost–benefit analysis, weighing the cost of preventing fraud against the loss incurred by it. However, as the losses caused by moral hazard have assumed serious proportions, it is time to think afresh on this issue.[14] The frequency and severity of insurance crimes, such as murder, have been increasing, and the confidence in the insurance industry has been decreasing. In order to prevent huge losses, insurance companies need to spend more money than they were previously supposed to. In other words, to cope with this problem appropriately, in addition to mandated prevention methods, a system to facilitate the conditions in which the agent can behave ethically is required. It can be said that the insurer should incorporate ethical values in their organizations in order to cope with the moral hazard problem in a better manner.

3.2 Corporate Scandals and "Mandated" Risk Control

In this section, I highlight a Japanese example to draw attention to the limits of "mandated" risk control. On June 27, 2000, the products of Snow Brand, the largest producer of dairy products in Japan, caused food poisoning.[15] All the plants of this company had been certified as "Hazard Analysis Critical Control

[11] The legal effect of misrepresentation of material facts and material concealment is that the contract becomes voidable at the insurer's discretion. Including the above-mentioned legal procedures, Takao (1978) and Takao (1980) provide the following examples as regards preventing the self-interested misbehavior of the insured: careful selection of applicants, risk sharing among both parties, and compulsory contractual provisions; on the other hand, as regards not taking advantage of the unequal possession of information in each party, using common terms in the policies, risk classification to reward good risks with better insurance rates, and careful underwriting.

[12] Takao (1978, 1980).

[13] Milgrom and Roberts (1992).

[14] In Japan, for example, after a murder was committed by a woman who had worked as a life insurance agent to collect life insurance proceeds, defects in the system for selecting applicants for insurance and insufficient education on professional ethics for life insurance agents were revealed. Most Japanese life insurance companies improved countermeasures to prevent fraudulent claims. The primary countermeasures are mentioned as follows: strengthening the connection with the police, policy data registration at the registration center of the Life Insurance Association of Japan, and a policy data inquiry system (http://seiho.or.jp/).

[15] Snow Brand distributed contaminated milk and failed to notify the public regarding this issue for two days, and as a result, more than 15,000 people fell ill.

Point-approved" (HACCP-approved) by the Ministry of Health, Labour, and Welfare. The high-quality safety standards for this certification should have prevented this incident. However, the company had not been maintaining its plants to the certified standards when the incident occurred. Further, in January 2002, it was revealed that one of Snow Brand's government subsidized subsidiaries was involved in the false labeling of beef products. As a result of these incidents, the Snow Brand group experienced huge direct and indirect losses.[16] The moral hazard in managerial decision making was named as one of the most serious factors that caused and increased the losses.

The regulations and self-regulations in the industry have become more stringent in response to such scandals. Soon after the occurrence of the abovementioned incident, all the Snow Brand plants with HACCP certifications were suspended.[17] A set of acts that sought to bolster food safety and protect public health in the wake of numerous recent scares was legislated in February 2003. One of the acts sanctioned the setting up of a government Food Safety Commission to evaluate the health effects of certain foods.[18]

However, the effects of such laws are also limited. Most of the recent scandals cannot be exclusively classified as legal or illegal. The managers made "not illegal, but unethical" decisions, which they considered to be the most rational to temporarily improve their results. However, as a consequence, they caused huge losses to their firms. Following the existing laws is a "mandated" risk control,[19] which forces managers to make legally appropriate decisions. In addition, it is necessary for managers to be eager not only to follow the existing laws but also to behave ethically. In other words, ethics-related risk control is a practice that serves the interests of a firm.

3.3 Ethics-Related Risk Control in Management

Ethics-related risk control is applicable to all types of firms. Managers (the agent) should be strictly controlled. As Friedman maintains in *Capitalism and Freedom*, self-interested actions tend to promote general welfare only when appropriate laws are in place. A variety of regulations are required to control the moral hazard by the manager. However, regulations alone cannot solve this problem.[20]

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[16] A Japanese research institute estimated that a series of scandals brought down the corporate value of the Snow Brand group by approximately ¥70 billion (*Nihon Keizai Shinbun*, March 11, 2002).

[17] In the United States, after the accounting scandals at Enron and WorldCom had been exposed, Congress passed the Sarbanes–Oxley Act on July 30, 2002. This act is formally named "Act to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities law, and for other purposes."

[18] *The Japan Times*, February 8, 2003.

[19] Young and Tippins (2001).

[20] In addition, as Carson (2003) highlights, rules, decision procedures, and schemes for reward and compensation need to be scrutinized for the incentives created by them.

The insurer (the principal) is required to facilitate the conditions for the insured (the agent) to behave ethically. Likewise, managers should be encouraged to behave ethically by their principals (all the stakeholders), specifically the stockholders. Further, it is the social responsibility of the managers that they control their moral hazards of their own accord and make ethical decisions as management professionals. It is not sufficient that managers themselves refrain from fraud and deception; they must also not condone or permit fraud and deception by subordinates or those who work for the corporation.[21]

Avoiding punishment under the existing laws is the main consideration taken by managers in making decisions. Although they regard such decisions as being best suited for the financial results of the firm, it can, in fact, lead to financial ruin. Whether the agent makes improper decisions is ultimately an ethical behavior beyond compliance with the laws. In addition to legal compliance, we must incorporate ethics as a form of risk management in firms.

4. Conclusion

The study of moral hazard in the insurance industry will contribute to a better understanding of moral hazard in all types of firms. Moral hazard implies the inefficiency factor in the insurance market. The insurance company should regard the moral hazard problem as one of the most urgent issues to cope with.

Meanwhile, moral hazard in managerial decision-making has been underestimated as a hazard for firms because it is extremely difficult to identify the relationship between moral hazards and losses and to quantify the indirect losses caused by them. Presently, we need to recognize the unethical decision making of managers as a moral hazard and cope with it accordingly.

In addition to mandated prevention methods, an ethical viewpoint is necessary to effectively cope with the moral hazard problem. It is also required for the stakeholders (the principals) to establish a system in order to support the ethical behavior of managers.[22]

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[21] Carson (2003), p. 393.

[22] Carson (2003) criticism is that the stakeholder theory makes extremely naive and unrealistic assumptions regarding the abilities and moral capacities of managers of corporations, and that it needs to add the explicit requirement that executives should not require, pressurize, or permit professionals who work for the firm to violate their own professional obligations, e.g., their obligations as accountants, lawyers, or engineers.

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3
Accounting and Corporate Governance

Yoko Nakoshi

1. Introduction

There is at present an attempt to use accounting more effectively so that it might also cause management to consider corporate governance as important. Moreover, this trend includes the recognition stage of accounting, exceeding the stage of disclosure. In reality, is accounting effective in making management consider corporate governance as important?

In this chapter I wish to consider accounting with regard to both these two levels, disclosure and recognition. I wish to consider the situation in which the importance of corporate governance is included in the setting of accounting standards as well as the situation in which accounting information is used in corporate governance.

2. The Enron Failure and the Sarbanes–Oxley Act

After the collapse of Enron, it was assumed in the United States that accounting for the special purpose entity was one of the causes of the failure.[1] The Enron failure generated a distrust of accounting in the United States. Under these conditions, the Public Company Accounting Reform and Investor Protection Act of 2002 was enacted. This is known as the Sarbanes–Oxley Act.

According to the Sarbanes–Oxley Act, accounting reform of the public company in order to protect investors is important. New regulations demand the reorganization of public companies to improve the quality of financial reporting. In the Sarbanes–Oxley Act, accounting is assumed to be an effective pillar in making management consider corporate governance as important. For instance, it even includes the content of the accounting standard, and the conversion from the detailed rule to the fundamental rule in the setting of accounting standards is provided for.

[1] See Powers (2002).

Regarding accounting standards based on fundamental rules, the unification of accounting standards by a standard-setting organization is aimed at. Historically in the United States, exceptional accounting methods were allowed and a wide variety of methods were permitted in business accounting.

In such a situation, against the rising problem of illegal accounting, there is at present a movement toward changes in accounting standards in the United States. For instance, accounting standards for stock options and the consolidation of the special-purpose entity have been changed.

3. Disclosure of Management Remuneration

First of all, in order to strengthen the watch on management and achieve the maximization of the stockholders' value, it is imperative that the accounting material is included in discussions of the board of directors and in the agenda of the stockholders' meeting. This is a situation in which accounting information is used for corporate governance.

The disclosure of management remuneration is of special concern in corporate governance. For instance, in the United States the remuneration of a chief executive officer (CEO) is disclosed according to the Securities and Exchange Law, and the remuneration of high-ranking persons is disclosed individually.

Moreover, the report set up by the remuneration committee of the managing board must be disclosed.[2] This report explains how management remuneration, including CEO remuneration, is decided. Additionally, it describes the relationship between corporate performance and management remuneration, and the measurement standard of corporate performance and managers' individual performance.

The U.S. Securities and Exchange Law and the aforementioned Sarbanes–Oxley Act aim to protect investors. Disclosed information is used from this viewpoint for the improvement of corporate governance. In addition, considerable revision has been made to the rules pertaining to listed companies on the New York Stock Exchange, and the importance of stockholders' approval is increasing.

The problem of corporate governance over management remuneration is one of "disclosure" where accounting information is used for corporate governance. Remuneration for each manager is disclosed individually, and the discussion over how the individual remuneration was decided upon is also disclosed in the aforementioned report set up by the remuneration committee of the board.

Information on the total amount of management remuneration is not made available by corporate governors, but for accounting purposes the total amount of remuneration is recognized as expenses.

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[2] See Regulation S-K.

4. Concrete Demand from Stockholders as to Accounting Method

4.1 Accounting for the Stock Option

There exists stock-based compensation (or remuneration) besides cash. Specifically, whether to expense the amount that corresponds to fair value of the stock option as compensation cost or only to disclose the condition of grant, at the time of giving the stock option, will show the profit as different in the financial statement.

In the United States, when an incentive stock option is given, details of the conditions are supposed to be disclosed in the notes to the financial statements. Moreover, the fair value of the stock option must be disclosed. However, the fair value of the stock option in the accounts does not have to be incurred as compensation costs.[3] Therefore, when giving the stock option, many enterprises avoid costing the fair value of the stock option under such a situation.

However, in the environment of the aforementioned accounting distrust that followed the Enron collapse, some enterprises expensed the fair value of the stock options in their closing accounts of the third quarter of 2002. These included General Electric, Coca-Cola, General Motors, and Citigroup. The number of such enterprises continues to increase.

The trend of expensing the fair value of the stock option as compensation cost has been assumed by some to be an answer to the atmosphere of accounting distrust. In the 1990s, expensing of the fair value of the stock option was not obligatory because many enterprises lobbied against expensing the fair value of the stock option[4] in setting accounting standards for it. It can be argued that some enterprises decided to expense the fair value of the stock option as compensation cost voluntarily only after corporate governance came to be considered as important as a result of the Enron failure and the distrust of accounting.

In the United States the amount given and the exercise price of the incentive stock option must be disclosed in the accounting standards. If there are any conditions of the achievement, such conditions must be disclosed clearly. Additionally, information on how the fair value of the stock option was calculated must be explained.

For instance, in the notes to the financial statements in Microsoft's annual report, the fair value of the stock option was calculated and disclosed along with the profit where expensing the fair value of the stock option. In fact many enterprises, including Microsoft, did not in actuality expense the fair value. The profit disclosed in the notes to the financial statements was not formal but called "pro forma earnings". This was used as the investors' reference. Moreover, even if pro forma earnings were not disclosed and the fair value of the incentive stock option

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[3] See FASB (1995) and FASB (2002c).
[4] Compare FASB (1993) with FASB (1995).

disclosed in the notes to the financial statements, the investors should still be able to calculate this informal profit for themselves.

In December 2002, the new accounting standard for stock-based compensation was issued.[5] The new standard does not oblige companies to expense the fair value of the stock option. However, it requires that the disclosure of the pro forma earnings in expensing the fair value of the stock option should be displayed more prominently.

One of the applications arising from the accounting distrust in the United States after the Enron failure was expensing of the fair value of the stock option as compensation cost, being an opportunity that adequate recognition of the accounting be required that exceeded the disclosure in the corporate governance. It might be shown that mere disclosure of the stock-based compensation was ineffectual even though the accounting information was used in corporate governance.

However, when the recognition of accounting is discussed, a theoretical discussion besides the viewpoint of useful or decision-making information for the investors is needed. Does corporate governance have an impact on the process of setting the accounting standard? Additionally, one should consider corporate governance within a theoretical framework.

4.2 Consolidation of Special-Purpose Entities

In January 2003 in the United States, the accounting standard of the consolidation of special-purpose entities was issued as an interpretation of the consolidation.[6] In this accounting standard, special-purpose entities are known as "variable-interest entities." This standard addressed the consolidation by a "primary beneficiary" of a variable-interest entity.

Whether or not to consolidate variable-interest entities is judged according to the degree of economic benefit and the risk of the business unit. The concept of the primary beneficiary in consolidation accounting was introduced because a failing Enron had not consolidated any special-purpose entities for a long time.

Even if the enterprise does not have the majority shareholding of the variable-interest entity created or acquired, the former may consolidate the latter. In business terms, the former is entering into various arrangements with the latter.

For instance, the variable interest entities created or acquired provide for, e.g., leasing certain properties, financing, development and operation of real estates, and implementation of the stock option plan.[7] If variable-interest entities are established by investment from two or more enterprises, the enterprise that is the "primary beneficiary" should consolidate the entities. In such a case, "primary beneficiary" depends upon the degree of exposing the loss and the risk and

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[5] See FASB (2002c).
[6] See FASB (2003).
[7] See Sony's 2003 and 2004 annual reports.

receiving the economic benefits, not upon the leadership and the right to vote possession. Thus, there is a new contradictory problem, since consolidation is not tied to the right of stockholders' vote possession.

5. Conclusion

In examining the interrelation between corporate governance and accounting, it can be said that the disclosure of remuneration has been encouraged for corporate governance. However, there is a movement from disclosure in the financial notes toward recognition in the accounts for stock-based compensation, so that this is shown in the stock option.

It is noteworthy that stockholders are proposing the application of a particular accounting method such as that already mentioned, and some enterprises are adopting it. It can be said that this constitutes a backup of corporate governance.

The directions prescribed are to recognize and to disclose within the accounting standard, and to recommend voluntary disclosure. At one time it was accepted that mere disclosure was enough because investors were able to interpret it. However, recently the idea of prescribing recognition in the accounting standard so as to interpret the accounting figures has become mainstream. As mentioned before, the particular accounting method of the incentive stock option proposed by stockholders has been gradually incorporated into the accounting standard.

Additionally, the stockholders' view was considered to be important, so the accounting standard for the consolidation of special-purpose entities was changed. In setting this accounting standard, corporate governance was also considered an important aspect. When the trends of the revision and the setting of such an accounting standard are observed, the accounting standards that have been influenced from the viewpoint of corporate governance apply not only to the disclosure level but also to the recognition level.

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4
Institutional Investors and Corporate Governance

Yumiko Miwa

1. Introduction

Corporate governance—how and by whom a corporation is controlled and ultimately who owns the corporation—has become common in Japan. In the United States, shareholders and management share the responsibility of corporate governance. On the contrary, in Japan corporate governance seems to include stakeholders, which comprise employees, creditors, customers, etc.

Until recently it was generally asserted that the Japanese corporate governance system had been effective because the management of a corporation could be monitored by banks and other corporations within the cross-stock holding system. Currently, the Japanese corporate governance system is undergoing changes in search of a more effective system. In Japan, the institutional investor has become involved in the corporate governance system using the shareholder proxy vote.

Also, institutional investors have another way to check the corporations in the stock market, classified as socially responsible investment (SRI). SRI is an investment method targeting companies that conduct their activities with corporate social responsibility (CSR), investing in companies which value CSR, and not merely taking corporate earnings from the marketplace.

2. The Transition of the Shareholder's Position in the Corporation

In 1932, Adolf A. Berle and Gardiner C. Means examined the phenomenon of "separation between ownership and control" of corporations in their monumental work on the corporation, *The Modern Corporation and Private Property*.[1] It can be argued that the most enduring theme of this work is the divorce of ownership from the control of the modern corporation. Berle and Means examined

[1] Berle and Means (1932), p. 66.

the concentration of economic power and the dispersed stockholding in the 1920s in America. They wrote about the concept of separation between ownership and control of a corporation, and applied the new form of corporation that was controlled by management.

Under what circumstances, then, had management control of a corporation been created? Originally, what kind of rights to control corporations did shareholders have? First, I will explore the general historical change of the control of a corporation under the corporate law.

The structure of a corporation under modern corporate law was established at the end of the nineteenth century. It is held that this structure reflected the democratic idea of a state: "mutual independence of the three powers of the legislature, the executive and the judiciary." Similarly, in a corporation there is the separation of the three powers of the shareholders' meeting, directors, and auditors. Of the three, the shareholders' meeting has the highest and most powerful function in deciding corporate matters. Directors can execute business according to the decisions made in shareholders' meetings; auditors oversee the execution of business by directors. In theory, every shareholder attends the shareholders' meetings to freely discuss corporate matters, to vote, and ultimately decide the course of the corporation.[2]

However, ownership and management cannot but separate in a corporate system because of its form. Under modern corporate law, the control of corporations could be left to shareholders through shareholders' meetings. However, because the resolution of the meeting is based on the capital majority, a corporation is controlled by the shareholder owning the shares comprising that majority. For example, if the control of a corporation depended upon the election of directors, the person owning the majority of issued stocks of a corporation would have the power of control, because the election of directors needs a majority of votes.

In addition, an entrepreneur shareholder who can solicit proxy cards and exercise their voting rights on behalf of shareholders who have no interest in the management of a corporation can control the corporation without holding the majority of issued stocks. Moreover, when a corporation becomes huge and shareholding is dispersed more widely, such an entrepreneur shareholder no longer exists. In this situation, the person who is capable of soliciting the proxy and exercising voting rights on behalf of shareholders can control the corporation. That is management.

Finally, management itself can control a corporation. In this way, shareholders who originally had the power to control the corporation have become similar to renters. As a result, the phenomenon of separation between ownership and control emerges.[3]

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[2] Kitazawa (1976), p. 208.
[3] Berle and Means (1932), pp. 66–83.

Now we return to the issue of American corporate law. Under American corporate law, management has the power to not only exercise business control but also decide general policy. However, it does require the agreement of shareholders regarding basic intentions concerning the organizational structure of the corporation. The function of election of directors (management) is left to the shareholders. Accordingly, this illustrates the mechanism by which shareholders control management. This is the general underpinning of American corporate law.[4] However, it should be noted that as Berle and Means pointed out, this kind of system is fictional, because management can be self-perpetuating. This is called the "management-control corporate organization."[5] Two different approaches to change this situation have been considered. One is to strengthen and amend the power given to shareholders to oversee management. This approach assumes that the mechanism by which shareholders control management under current corporate law is not entirely ineffective and tries to reestablish the idea of corporate law, i.e., the control of management by shareholders. This idea is called shareholder democracy, or alternatively, corporate democracy.

In contrast, the second approach suggests that the current concept of corporate law no longer has any significance and a new system is required.[6] Shareholder democracy insists that shareholders should participate in corporate governance actively and play the role of management monitor. To accomplish this goal, various measures are considered.

First, the disclosure of information to each shareholder is necessary for them to judge adequately the behavior of management and the proposals that are submitted during the meeting. Second, a system by which shareholders can exercise easily their voting rights according to their own decisions is necessary. Third, a system by which shareholders can communicate easily among themselves is needed, since each shareholder owns a fraction of the stocks. The Full Disclosure principle under the SEC proxy rule and its part, the shareholder proposal rule (rule 14a-8(4)), were legislative efforts to satisfy these requirements.[7]

Recently, American institutional investors have used the shareholder proposal rule.[8] What does this phenomenon mean? If management control is based on the assumption of the non-exercise of voting rights and the power of soliciting proxies, once institutional investors exercise their voting rights according to their own decisions, management control will disintegrate and the control of a corporation will fall into the hands of institutional investors. Next we will examine the incentive of institutional investors to participate in corporate governance matters and determine their level of success.

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[4] Clark (1986), pp. 93–109.
[5] Berle and Means (1932) p. 78.
[6] Dent (1985) p. 2.
[7] Maeda (1974) p. 460.
[8] Clark (1990) p. 79.

3. The Check System from the Investment: Socially Responsible Investment

In recent years, socially responsible investment (SRI) has garnered attention worldwide. SRI is an investment method targeting companies that conduct their activities with corporate social responsibility (CSR), investing in companies which value CSR, and not just taking corporate earnings from the marketplace. CSR signifies operating a business by interacting positively and consulting with equity stakeholders concerning corporate environmental policies, strict adherence to the law, consideration of human rights, consumer response, maintaining a positive work environment, contributing to the region, etc.

In the modern era with globalization of corporate activities, cries of concern about this international influence are growing louder. In the 1990s, ocean waste from Royal Dutch oil storage facilities and low wages paid by Nike in developing countries became international problems. With this kind of multinational company problems as a backdrop, interest in CSR increased. In 1999 the UN Secretary General Kofi Annan advocated the Global Compact, nine principles regarding human rights, labor, and environmental issues. In 2000, the OECD revised its standard of conduct for multinational companies, and in 2001 the ISO (International Standards Organization) began to consider standardization of CSR. In the same year the European Commission proposed promotion of CSR, and there was a move toward standardization of CSR.[9]

In the United States also, because of the collapse of Enron and WorldCom, which were representative of U.S.-style businesses, the move strengthened to reexamine the way management should carry on in order to maximize shareholder value. And with recognition in the United States of the need to promote inclusion of CSR in business as a backdrop, the role of government has decreased, and businesses have ventured out to make use of public resources like schools, which until now had been outside the parameters of the market.[10]

In Japan too, stock brokerage loss compensation problems appeared at the beginning of the 1990s, and after that more problems, such as financial industry scandals, appeared, putting corporate social responsibility into question; in 1991 the Keidanren (Japan Federation of Economic Organizations—currently The Japan Business Federation) set up the Charter for Good Corporate Behavior, which companies were expected to follow. However, after that, scandals in Keidanren-member companies erupted one after another, and in May 2004 it revised the charter for the third time, with contents including social justice and environmental management stressing CSR even more. The Keidanren insisted that companies should proceed with involvement in CSR autonomously, and took a position opposing standardization or legislating CSR.[11] The Japan Association

[9] *Nihon Keizai Shinbun* "Good management—Question about CSR," Jan. 14, 2004.
[10] *Nihon Keizai Shinbun* "CSR and the future of the corporation," Oct. 19, 2004.
[11] *Nihon Keizai Shinbun* "The importance of CSR," May 18, 2004.

of Corporate Executives issued its Corporate White Paper in 2003, clearly spelling out the importance of CSR. Interest in CSR is high among individual companies, and when the *Nihon Keizai Shimbun* canvassed about 1000 major large companies in FY 2003, about 45% had begun involvement in CSR, while a mere 2.8% responded that it "wasn't necessary."[12]

In today's world, recognition of CSR is increasing and many companies are making CSR integral in their businesses. Against this background, influence on companies is increasing through lively interest in SRI by institutional investors; in other words, the power of investment.

If one considers, for example, tobacco companies in the United States, which are on the frontline of criticism, they have boosted profits and shifted huge costs to the public. Institutional investors like the gigantic CalPERS, the California Public Employees' Retirement System, have demanded that companies eliminate these costs, and this is one reason companies have turned toward CSR. SRI amounts have reached about $2 trillion in the United States and about $3 trillion worldwide. Amy Domini, who developed the world's first SRI stock index, the Domini 400, has attracted a wide range of capital with the mottoes of "changing society through stock investment" and "investors changing corporate management," and has garnered interest in her method of investing by selecting companies with a high level of social contribution in areas like the environment and human rights.

In recent years, large-scale institutional investors such as pension funds in Europe and the United States have adopted this kind of investment method. In Japan too, the Tokyo Metropolitan School Personnel Mutual Aid Association began an SRI in 2003 to invest in companies which contribute to the region through education and which actively promote and support their employees' education.[13]

Through this kind of stock investment, investors are trying to promote corporate management that will fulfill its social responsibility and indeed change society, and expectations on institutional investors are ever increasing to have the right to make investment decisions and have the right to say something to corporate management.

3.1 SRI Funds in Japan

The first SRI in Japan was the Eco Fund, established in August 1999 by Nikko Asset Management. After that, Asahi Life Asset Management began to sell Asu no Hane in September 2000, a true SRI fund that evaluates additional social aspects, such as consumer response, employment, and social contributions. As of December 2003, publicly subscribed investment trusts had established 18 such funds.

[12] *Nihon Keizai Shinbun* "Good management—Question about CSR," Jan. 14, 2004.
[13] *Nihon Keizai Shinbun* "CSR and the future of the corporation," Oct. 19, 2004.

Market capitalization in publicly subscribed SRIs was ¥60 billion in March 2003 when stock prices hit their recent lows. This is one third of the ¥200 billion at the peak period in 1999.[14] Total assets of investment trusts as of the end of September 2004 were about ¥14 trillion, and for the approximately 2500 established funds, the amount invested in SRI funds was extremely small, although it was expected to increase in the future due to continuing corporate scandals and increasing foreign equity shareholder stakes.[15] Yet the majority of investment results for SRI investment trusts that have been established up to this point were down by double digits, and for the individual investor they are not currently viewed as attractive items.

SRI investment by institutional investors has recently begun. In 2003 the Tokyo Metropolitan School Personnel Mutual Aid Association contributed ¥2 billion of the ¥84-billion reserves in its pension fund as a special investment fund and began investing by establishing a self-directed investment SRI fund. The SRI fund carries out investment in companies based on their evaluation of such societal aspects as taking care of the environment. In July 2003 Sumitomo Trust & Banking became trustee for the ¥2.5-billion Sustainable Growth SRI fund, combining the pension funds of KDDI and Shinsei Bank. Then in December 2003 Fukoku Mutual Life Insurance Company, and in January 2004 Mitsui Asset Trust Bank announced they would establish SRI funds for their pension plans.[16]

In July 2003, according to the results of a questionnaire conducted by Sumitomo Trust & Banking of corporate pensions which institutional investors represent, about 65% of the pension funds look upon SRI funds as more than "one possible consideration," a relatively high rate for something where the awareness is not high. And a very high 47% responded "agree" to the statement "SRI's are a new excess revenue source." These two data mean that for corporate pensions, when they are confident that SRIs are a source for returns, SRIs can become an investment objective. In other words, this suggests the possibility that in the future, SRIs can assume the position of an active investment for Japan's pension funds. The key to this, though, is whether they can maintain performance as an active investment means.[17]

In this way, Japan's institutional investors are demonstrating a constructive posture toward SRIs. In the midst of this, the Pension Fund Association and the Pension Fund Association for Local Government Officials decide by themselves how to exercise their voting rights in a positive way and, without any direct corporate influence, thereby have something to say about CSR in each and every corporate governance principle.

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[14] Adachi and Kanai (2004) pp. 83–85.
[15] Investment Trust Association (2004).
[16] *Nihon Keizai Shinbun* "Investment into the CSR Fund," May 27, 2003.
[17] Adachi and Kanai (2003) pp. 85–91.

3.2 Evaluating the Performance of Japan's SRI Funds

As discussed previously, with investment results in SRI funds in Japan registering a double-digit decline or more, they are not attractive items for investors. However, this is more a problem confined to a certain point in time, and performance is not a problem that is limited to SRIs. In 2003 Morningstar, which is a company that rates investment trusts, developed an SRI index for Japanese stocks, and it has enjoyed a favorable reputation since it began on May 30, 2003. Looking at returns from May 30, 2003 to the end of December in the same year, the Morningstar SRI (MS-SRI) stood at 26.57%, two percentage points higher than the 24.58% for the TOPIX.

Morningstar back-tested the previous 10 years for the MS-SRI (an investment simulation going back to March 1993 for the May 2003 portfolio), and the results show that the MS-SRI would have been 20.56 percentage points higher than the TOPIX rate of –44.97%.[18]

Based on research up to this time, the performance of the U.S. SRI funds and SRI indices in the 1990s do not show results worse than market indices. Moreover, it has been verified that the returns on SRI indices developed in recent years in Japan also are better than the performance of traditional stock market indices. This shows that there is no contradiction between institutional investors selecting SRIs as investments and fulfilling their fiduciary responsibility. And when it comes to having a different investment universe, it shows that in recent years SRIs have become an important investment for institutional investors who are trying to make alternative investments more positive.

SRIs are one social system which influences the way corporate governance should be, and manifest a relationship by which the company is influenced by the equity stakeholder, and at the same time influences the equity stakeholder, that is, SRIs are a model of mutual enhancement between company and equity stakeholder.[19]

For example, on examining an eco-fund, one sees that it rates a company's environmental policy objectively. The company implements its environmental policy and promotes its environmental policy information disclosure in a positive manner. The eco-fund again evaluates the results. By generating positive feedback, the eco-fund plays the role of an impetus towards a sustainable society.

4. Conclusion

The phenomenon of separating the functions of corporate ownership and corporate control is common to the countries in which capitalism has developed. With the development of capitalism, the control of corporations has fallen into

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[18] Adachi and Kanai (2003) p. 91.
[19] Tanimoto (2003) pp. 239–244.

management's hands. Management can perpetuate itself in management-control corporations. It has been said that shareholders do not have any functions of control of corporations.

However, institutional investors have grown to substantial size and own significant percentages of individual corporations. Therefore, it has become more rational for institutional investors to monitor management. Institutional investors can use their voting right to change the corporate governance. This is called "shareholder activism."

Institutional investors have another way to change the corporation: SRI. This way includes more stakeholders. In recent years SRI has become an important investment for institutional investors who are trying to make alternative investments more positive. SRI could be a very good way to change corporations from within the capital market for a sustainable society.

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Part II
Corporate Governance in Japan

5 Institutional Investors Exercising Shareholder Voting Rights in Japan

Yumiko Miwa

1. Introduction

In Japan in recent years, fiduciary investment institutions such as the Pension Fund Association and public pensions as well as investment advisors have created guidelines for exercising shareholder voting rights, and have been actively endeavoring in exercising these rights. Participation in corporate governance by American institutional investors is exerting great influence in movements such as these.

Foreign stock investment by American institutional investors was centered in Europe in the 1990s. In recent years, with the increase in index investing and an eye toward the effects of risk diversification, there has been an increased amount of investment in Asian and other countries. With investment in foreign stocks increasing, American institutional investors have also come to exert influence on overseas corporate governance. When obstacles arise in taking actions such as these, appeals are made to respective national governments through international organizations such as the OECD, and actions are taken to demand systemic revision. In this way, positions taken toward American institutional investors' corporate governance come to have strong influence around the world.[1] Actions like these have such huge international impact that French and German researchers have concerns about a "new imperialism."[2]

What does this mean for a stock-held corporation system in which "separation of ownership and management" has been ever increasing? Do institutional investors who have fiduciary responsibility bear a responsibility that differs from that of simply a large shareholder? In this chapter, based on this premise of the issues, I will describe the current circumstances surrounding exercising shareholder voting rights by institutional investors in Japan, and examine the significance of this in the stock-held corporation system.

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[1] Miwa (2002), pp. 111–146.
[2] *Financial Times*, Feb. 5, 2001.

2. The State of Exercising Shareholder Voting Rights in Corporate Pensions

In both the United States and Japan, a simple corporate pension is conservative toward exercising shareholder voting rights due mainly to its relationship with the mother company. In this section, I present an overview of the trend in the Pension Fund Association, which has actively endeavored to exercise shareholder voting rights since 1998.

2.1 State of Asset Investment of the Pension Fund Association (PFA)

As of the end of FY2000, the PFA had approximately ¥60 trillion in assets and approximately ¥20 trillion under stock investment (¥1.4 trillion by the Association alone). This dominated about 5.4% of the stock market. Looking at this from an asset composition percentage, the percentage invested in stock at the end of FY2001 was 32%. The PFA's investment yield was a minus return in FY2000 and FY2001.[3] Tomomi Yano, the Executive Vice President of PFA, says the following about this situation.

> Earnings from Japanese stocks, to be blunt, are terrible. Through the 80s they were good, but in the latter half of the 90s they were pitiful, even worse than bonds. In years like FY2000, the stock market declined by 25%, and the pension's return was a pitiful negative 10%. The market continues to decline, and at this rate I fear we'll have a double-digit negative return for a second year in a row.
>
> This is a systemic investment problem in Japanese industries, and if I may say, I think it will become a corporate governance issue. . . . Management differs from the U.S. or Europe, and it looks like there's some funny business going on. I can't help but think that's why the stock earnings ratio has dropped so much.[4]

So one of the major reasons for the downturn in the PFA's investment earnings is found in the recognition that there is a problem in corporate governance, and the PFA became active in exercising shareholder voting rights. Next, I will present an overview of the state of exercising shareholder voting rights by the PFA.

2.2 Thoughts and Response Toward Exercising Shareholder Voting Rights (Table 1)

Amidst the downturn in investment returns in pension funds, increasing pressure from foreign stockholders, and increasing rates of stock holding by Japanese institutional investors, there has been an emphasis on the need for participation in

[3] Pension Fund Association (2001).
[4] Yano (2002), p. 25.

Table 1. Response by institutional investors toward shareholder voting rights

Year	Event
1998	• Study Group on Corporate Governance of Pension Funds officially publishes *Action Guide for Pension Funds to Exercise Voting Rights*
1999	• Nippon Life Insurance Company, Dai-ichi Mutual Life Insurance Company, Sumitomo Life Insurance Company, Toyo Trust Bank, Yasuda Trust Bank, and Sumitomo Trust Bank create guidelines for exercising voting rights
2000	• Pension Fund Association officially publishes *Fiduciary Responsibilities Handbook (Investing Institutions Edition)*
2001	• Pension Fund Association devises Basic Investment Policies and Management Policies Regarding Exercising Voting Rights
	• Federation of National Public Service Personnel Mutual Aid Associations revises Basic Investment Policies and Management Policies Regarding Exercising Voting Rights
	• Pension Fund Association for Local Government Officials revises Basic Investment Policies and Management Policies Regarding Exercising Voting Rights
	• Comprehensive Research Committee of the Life Insurance Academy officially publishes *Regarding Fiduciary Responsibilities and Corporate Governance—Comprehensive Study Based on Data of Japanese Life Insurance Companies*[a]
	• Ministry of Finance Policy Research Institute officially publishes *Questionnaire Regarding Corporate Governance of Japanese Institutional Investors*[b]
	• Government Pension Investment Fund officially publishes results of shareholder meetings held April–June 2001
	• Pension Fund Association officially publishes *Practical Guidelines Regarding Exercising Voting Rights*
2002	• Pension Fund Association for Local Government Officials officially publishes "Corporate Governance Principles (Draft)" in *Interim Report of the Study Group on Basic Funds Investment Issues*
	• Pension Fund Association for Local Government Officials conducts a questionnaire and holds hearings studying how trust investment organizations implemented voting rights with regard to proposals and bills at regular shareholder meetings of companies that are registered in Japan as of the end of March and hold trust investments
	• Japan Securities Investment Advisors Association Study Group on Exercising Shareholder Rights including Voting Rights officially publishes *On Discretionary Investment Companies Exercising Shareholder Rights Including Voting Rights*
	• Japan Securities Investment Advisors Association conducts Questionnaire to Study Exercising Voting Rights

[a] Comprehensive Research Committee of the Life Insurance Academy (2002)
[b] Ministry of Finance Policy Research Institute (2001)

corporate governance by institutional investors. The Study Group on Corporate Governance in Pension Funds commissioned by the Pension Fund Association in June 1998 compiled its report and published the *Action Guide for Pension Funds to Exercise Voting Rights*.[5]

In the report, it says that in order to give form to pension funds' corporate governance activities, the first step is to appropriately exercise shareholder voting rights, which are one of the basic rights of a shareholder, and it had compiled the *Action Guide* in order to do this.

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[5] Pension Fund Study Group on Corporate Governance (1998).

Managers who are directors of pension funds that bear a fiduciary responsibility must think that increasing the return for the fund is the only purpose of their work in asset investing or asset management. Shareholder rights, beginning with the voting rights of stocks which are an asset of the pension fund, should be voted in order to accomplish this objective. The mission of the pension fund is to demand from the point of view of a shareholder that the board of directors manage the business to increase the value of the stock in the long term. As one opportunity to convey to the board of directors the expectations of the pension fund, and with the recognition that they can effectively utilize their 'Voting Rights,' the pension fund should integrate its exercising of voting rights together with concrete action.[6]

This report also emphasizes the necessity of the pension fund, based in its fiduciary responsibility, to discharge the duty of the shareholder to oversee corporate activities. There are two oversight standards, first whether the board of directors is managing the enterprise with a view to maximizing shareholder return, and second that the board of directors bears a duty of clarification (accountability) to the stockholder and whether they carry out timely and pertinent information disclosure about corporate activities. As illustrated in these standards, exercise of shareholder voting rights is considered number one as a concrete method to oversee corporate operations, and for the time being these activities must be implemented through investment fiduciary institutions. Under present circumstances, when it comes to pension funds exercising shareholder voting rights, there are constraints due to the structure of the process because clerical handling and corporate analysis abilities are still somewhat underdeveloped. Therefore, investment fiduciary institutions are actually appointed sole discretion in exercising shareholder voting rights, but as pointed out in the report, are encouraged to devise concrete standards for exercising voting rights. Those points in the report span seven items in the corporate culture: the structure of the board of directors, its scope, the quality of the board of directors and corporate auditors, the distribution of earnings, changes in corporate finance strategy and business operations. In April 2000, the *Fiduciary Responsibilities Handbook (Investing Institutions Edition)*[7] was published, and the fiduciary responsibilities of asset investment institutions were more clearly defined.

In addition, in October 2001, the Pension Fund Association officially published the *Practical Guidelines Regarding Exercising Voting Rights*.[8] These guidelines amplified the basic policies of the association from the perspective of businessmen, served to clarify the purpose of exercising shareholder voting rights, and for the time being limited application to fiduciary institutions of domestic stocks. These guidelines provided the following items in order to unify the basic thoughts of the association and fiduciary institutions regarding exercising shareholder voting rights: (1) each fiduciary institution, in order to maximize the return for

[6] Pension Fund Study Group on Corporate Governance (1998).
[7] See http://www.pfa.or.jp
[8] See http://www.pfa.or.jp/toukei/jittai/pdf/chosa_gaiyou.pdf

those who withdraw mid-course and others, shall receive a proxy from the association as trust grantor, and shall exercise shareholder voting rights based on its fiduciary responsibility; (2) shall promote management which views seriously shareholder returns; and (3) shall promote information disclosure to shareholders.

They also address the following to set up a system for fiduciary institutions to exercise shareholder voting rights. Firstly, fiduciary institutions should set up a system to exercise shareholder voting rights, clearly stipulating a decision-making process for asset organization and operational methods in proposed bills. In addition, in these cases it is desirable to designate someone with full-time responsibility for the clerical work involved in exercising shareholder voting rights. Also, the guidelines require that each fiduciary institution devise concrete standards (guidelines) for exercising shareholder voting rights.

In devising these guidelines, it is also required that they consider the decision-making standards the association has established. Those decision-making standards the association has established are divided into eight headings and all of these express the association's standards: (1) structure of board of directors, (2) size of board of directors, (3) functions required in board of directors, (4) functions required in corporate auditors, (5) distribution of earnings, etc., (6) changes in corporate finance strategies and business matters, (7) corporate social responsibility, (8) other decision-making standards.

Fiduciary institutions must report to the association concerning, among others things, (1) system of exercising shareholder voting rights, (2) concrete standards for exercising shareholder voting rights, and (3) screening standards. The association will consider efforts regarding exercising shareholder voting rights as one element in its quantitative evaluation of management and investment.

The state of exercising shareholder voting rights by fiduciary institutions which had settled their books during FY2001 was published by the association.[9] There were 11 fiduciary institutions to which the association had given in trust the investment of its domestic stocks, and among those, there were four companies which had designated a person with full-time responsibility for exercising voting rights, and there were six companies which had established screening standards. Among companies in which problems were recognized in corporate operations, the largest number was 55 cases, instances of companies conferring retirement bonuses for resigning directors (including resigning corporate auditors). Then there were 45 cases of opposition or abstention. Yet there was not even one fiduciary institution that sold its shares.

Thus the Pension Fund Association has worked very hard at positively exercising shareholder voting rights among Japan's institutional investors through its *Practical Guidelines* etc.

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[9] See http://www.pfa.or.jp

3. Exercising Shareholder Voting Rights in Public Pensions

Next I present an overview of the state of exercising voting rights in public pensions. I will focus on efforts in the Government Pension Investment Fund and the Pension Fund Association for Local Government Officials, in both of which the amount of investment assets is large among public pensions.

3.1 The State of Asset Investment of the Government Pension Investment Fund

The Government Pension Investment Fund was established in April 2001 through the enactment of the Self Investment Law of the Public Pension System Revision Act of March 2000. With regard to investment of public pension reserves, until this time there had been an obligation to deposit the reserves with the Trust Fund Bureau of the (former) Ministry of Finance, but this was abolished and from 2001, self investment was approved for the Government Pension Investment Fund.

The goal of self investment of the pension reserves is to contribute to the stabilization of the operation of the pension business by conducting the investment safely and effectively for the sole benefit of the insured, and the Ministry of Health, Labour and Welfare manages the investment and causes the Government Pension Investment Fund to conduct the investment. The Ministry of Health, Labour and Welfare sets up basic policies regarding the investment of the pension reserves, and makes clear the duties of employees investing them. The ministry makes and publishes a detailed report each fiscal year regarding the investment results of the pension reserves, the influences on the pension's financial affairs, an evaluation of the investment, etc. In addition, the ministry continues to duly consider the stable operation of the pension's financial affairs, and considers necessary interim measures so amounts moved to market investment gradually increase while scrupulously considering the effect on the markets and raising funds in connection with the continuation of outstanding loans of the Trust Fund Bureau of the (former) Ministry of Finance. The Government Pension Investment Fund manages and invests pension funds according to basic policies determined by the Ministry of Health, Labour and Welfare.

The target investment return for the new pension assets was set at 4.5%, and in order to assure this target return, the decision was made to invest 68% of the total assets in domestic bonds, 12% in domestic stocks, 7% in foreign bonds, 8% in foreign stocks, and 5% in short-term assets. A certain leeway was built into the asset distribution structure. Domestic stocks, for example, could be increased or decreased by 6 points from the 12% mark. Refunding from the Trust Fund Bureau of the (former) Ministry of Finance would take 7 years, and this asset distribution plan would be applied to the composition of the entire reserves after the completion of the refunding. Reserves are estimated to be ¥150 trillion

around year 2010, and of that, if 12% is attributed to stocks, the stock portfolio will be worth ¥18 trillion.[10]

As of the end of June 2002, about ¥15 trillion (54.48% of the composition) was invested in domestic bonds, about ¥6.7 trillion (24.24% of the composition) in domestic stocks, ¥1.6 trillion (5.88% of the composition) in foreign bonds, ¥3.7 trillion (13.53% of the composition) in foreign stocks, and ¥0.5 trillion (1.87% of the composition) in short-term assets.[11]

The investment technique is centered on passive investing, since the amount of pension reserves is huge and it is necessary to consider seriously its effect on the market, and since the market is thought of as effective in the long term. They will increase the percentage in steps. In FY2004, the goal was to increase the percentage under passive investment up to 50%.

3.2 Exercising Shareholder Voting Rights of the Government Pension Investment Fund

Of the total pension assets that the Government Pension Investment Fund invests, the amount in its stock portfolio rose to about ¥6.7 trillion as of the end of June 2002. American public employee pension funds such as CalPERS have participated in corporate governance since the latter half of the 1980s by exercising voting rights, and these public employee pension funds have adopted advance funding methods. It is rare throughout the world for public pension funds that have adopted a taxation method to invest in stocks. Alone they comprise the largest shareholder, with ¥7 trillion in capital already invested in stocks in Japan.

The Government Pension Investment Fund was established in April 2001. There was a gradual conversion to self-investment through which the Ministry of Health, Labour and Welfare made its own direct investment, and as they continued to increase the amount invested in stock, they developed policies to clarify shareholder voting rights. The Ministry of Health, Labour and Welfare submitted basic principles to the fiduciary investment institutions that they had entrusted with investment that they should exercise voting rights giving highest priority to shareholder returns, and they would oversee the activities of the fiduciary investment institutions. They state the following about exercising voting rights in their basic investment policies of July 2001.

> The Fund, when giving charge to investment fiduciary institutions, clearly points out that the exercise of voting rights shall be carried out with the purpose of increasing solely the economic return of the Fund, and investment fiduciary institutions accepting this charge shall exercise these rights viewing their purpose as maximizing long-term shareholder return.

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[10] *Nihon Keizai Shimbun*, "Self-Investment of Public Pension Reserves Domestic Bonds 68%, Stocks 12% Deliberation Committee Report Distribution Change in 10 Years," December 23, 2000.

[11] See http://www.chikyoren.go.jp/shoukai/h13kesan/h13kesan.pdf

Along with the Fund setting forth its basic thoughts regarding exercising voting rights in our 'Management Investment Policies,' we request a report on the policies of the investment fiduciary institution regarding exercising voting rights and the state of their exercise. In addition, the Fund requests a report on the policy of how the investment fiduciary institution is to respond in case there are antisocial acts in a company and the circumstances of such response.[12]

Also, it states the following about management investment policies.

Exercising shareholder voting rights is natural for shareholders whose goal is investment returns, but when the Fund which is a public institution exercises direct voting rights, there are fears that such actions could give rise to concerns that the country is exerting influence on private corporate operations, and so the Fund does not directly implement these but leaves the decision to private investment institutions that have been given charge of investing. In such case, the Fund, when it gives charge to an investment fiduciary institution, expresses that the purpose of exercising voting rights is to maximize long-term shareholder benefits. The Fund, along with setting forth its thoughts as stated above regarding stock voting rights in the 'Management Investment Policies,' requests reports on the policies of the investment fiduciary institution regarding the exercise of voting rights and the state of their exercise. In addition, the Fund requests a report on the response of the investment fiduciary institution in case there are antisocial acts in a company.[13]

In the future due to this, an increase will be visible in "no" votes at stockholder meetings on proposals which are feared to hurt the value of the company. The Ministry of Health, Labour and Welfare first devises basic principles, conveys those policies before shareholder meetings to investment trustees such as trust banks, life insurance companies, investment advisor firms, etc., and asks what type of action they will take. It is considering having them report what type of actions they took after the shareholder meeting.

3.3 State of Asset Investment of the Pension Fund Association for Local Government Officials

The Pension Fund Association for Local Government Officials manages its long-term benefits reserves to smoothly execute the long-term benefits work of its mutual-aid member societies, and if a shortfall were to arise in the future in the capital for pension benefits of its mutual-aid member societies, the association serves in the role of providing any such necessary amount. Each mutual-aid member society pays into the association as long-term benefits reserves an amount corresponding to 30% of the estimated amount of incremental reserves. As of the end of FY2000, the long-term benefits reserve amount totaled about ¥13 trillion, and about 60% of this comprised payments from the mutual-aid member societies and 40% was investment returns.

[12] Government Pension Investment Fund (2001a); Yonezawa and Hashimoto (2002), p. 7.
[13] Government Pension Investment Fund (2001b).

About 53% of the long-term reserves are in compulsory investments. A compulsory investment is the portion with which they are obliged to acquire regional bonds as government administration support and bonds of government-sponsored entities as well as to make deposits in the fiscal loan fund of the Ministry of Finance. About ¥5.4 trillion, corresponding to another 41%, is trust investment, and the remaining 6% is invested in-house in bonds and other instruments. Among trust investments, about ¥2 trillion is invested in stocks.[14]

3.4 Exercising Shareholder Voting Rights of the Pension Fund Association for Local Government Officials

At the Pension Fund Association for Local Government Officials, it was also considered how to exercise shareholder voting rights in the Study Group on Basic Issues in Capital Investment in March 2001. In this interim report they wrote the Principles of Corporate Governance (Draft) in July 2001, and the section on exercising voting rights in the basic policies for investment was revised and made firmer.

> Shareholder voting rights shall be exercised so the company conducts corporate operations in order to maximize shareholder returns in the long term.
>
> In cases when the Association gives out instructions on exercising these rights individually, the fiduciary shall exercise the rights according to the instructions, and in cases when it does not give out instructions on exercising these rights individually, the fiduciary shall exercise these rights according to the policies regarding exercising shareholder voting rights which the fiduciary created and the Association approved.
>
> The Association shall request a report of the fiduciary on the state of its exercising shareholder voting rights.[15]

In addition, the following is stated in the Management Investment Policies on the subject of exercising voting rights.

> i. Basic Thinking When Exercising Shareholder Voting Rights.
>
> Shareholder voting rights shall be exercised in investment fiduciary institutions so companies conduct corporate operations in order to maximize shareholder returns in the long term.
>
> ii. Investment fiduciary institutions having policies regarding investment fiduciary institutions' exercising shareholder voting rights and the state of such voting rights shall submit to the Fund the policies regarding exercising shareholder voting rights. In addition, investment fiduciary institutions must make clear in these policies how they will respond in situations when there are antisocial actions by the company. The investment fiduciary institution shall report to the Fund every fiscal year on the state of its exercising shareholder voting rights.[16]

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[14] Pension Fund Association for Local Government Officials (2001a).
[15] Pension Fund Association for Local Government Officials (2001b); Yonezawa and Hashimoto (2002).
[16] See http://www.pfa.or.jp/toukei/jittai/pdf/chosa_gaiyou.pdf

In this way, the Pension Fund Association for Local Government Officials has also begun to show its positive response toward exercising shareholder voting rights. In the June 2002 shareholder-meeting season, it was firstly confirmed in separate consultations that there were no conflicts between the gist of the Pension Fund Association for Local Government Officials' Corporate Governance Guidelines (Draft) and those fiduciary institutions' guidelines for exercising voting rights, and comprehensive instructions were implemented with each fiduciary investment institution on exercising shareholder voting rights. Also in the June shareholder meetings, each fiduciary institution exercised shareholder voting rights. In August, the Pension Fund Association for Local Government Officials conducted hearings with each fiduciary institution on the state of exercising their voting rights. There were 5562 companies (aggregate number) whose stock was held by the Pension Fund Association for Local Government Officials through trust investment and in which voting was conducted, and there were 30,141 petitions (aggregate number) to be voted on. Combining the "yes" votes (73%) and the "blank proxies" (23%), 96% of all the submitted proposals were approved. Three percent of the total were opposed. The rate of "no" votes was relatively high, and looking at the proposals by category, they were Proposals for Such Things as Director Remuneration and Proposals Regarding Corporate Audit Committee/Auditors. Also, regarding response to corporate antisocial actions such as scandals caused by companies that had violated the law, these proposals were examined individually in detail.

In public pensions too, there have been very positive endeavors toward shareholder voting rights since sections on shareholder voting rights were established in basic investment policies, voting rights were given a place in investment assets, and the rate of exercising voting rights (for, against, abstention/total number of voting rights) exceeded 70%. However, pension funds like the Pension Fund Association and public pensions are not the main entities exercising voting rights; rather they stop at setting guidelines, etc., and leave the decision making to the fiduciary institutions.

4. Efforts of Fiduciary Institutions

Next, I examine the state of efforts of fiduciary institutions charged with the investments of pension funds. These fiduciary institutions of the pension funds are trust banks, life insurance companies, and also investment advisor firms for which entrance to the field of investment of assets of employee pension funds and the Pension Fund Association was approved in 1990. In this section, I will clarify the sudden upsurge in the trust balances of pensions in recent years, and the efforts of investment advisor firms which published the industry self-regulation rule in April 2002 regarding the appropriate exercise of instructions for exercising voting rights in (sole-) discretionary investment contracts.

4.1 A Chronicle of Exercising Shareholder Voting Rights in Investment Advisor Firms

As stated before, investment advisor firms were permitted to enter the field of pension fund investment in 1990, and at this time, the authority for instructions to exercise voting rights was included in "necessary authority to carry out investment for customers concerned" stipulated in the Investment Advisor Industry Act Article 2 Section 4, and an understanding was indicated that discretionary investment firms could receive a proxy for the right of instruction if necessary to carry out investment.[17] In accordance with this notice of understanding, investment advisor firms implemented instructions for exercising voting based on their discretionary investment contract with clients.[18] However, sometimes the significance or evaluation of the voting instructions was not determined, or interest on the client's part was low, or from the style of the investment the so-called Wall Street Rules came to be the dominant factor, or since some points may be unclear in the Investment Advisor Industry Act regarding exercising voting rights, in actuality, the client and the investment advisor firm jointly recognized that when it came to exercising shareholder voting rights, this may just be something that happens incidental to stock investing.

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[17] Former Ministry of Finance Notice: On March 16, 1990, an interoffice communication was sent out from the Director, Investment Management Office, Operations Division, Securities Bureau, former Ministry of Finance on exercising voting rights in asset investments of the employee pension funds, etc. (afterwards, in 1992, it was put in the form of a notice (July 20, 1992 Japan MOF Secu. #993)). In it, the following policies were set forth: (1) Exercising rights of decision, etc., shall be carried out only to seek general benefit of the client, and instructions shall not be carried out to seek benefit of a third party other than the client or oneself. (2) When exercising rights of decision, no instructions from the client shall be received. (3) In exercising rights of decision, data shall be maintained in written form on the process of how the substance of instructions on specific items was determined and on the basis for that determination.

[18] Three-Party Agreement on Exercising Voting Rights: discretionary investment firms are conferred the authority for exercising voting rights when so stipulated in the discretionary investment contract with the client. There are no particular stipulations in the Investment Advisor Industry Act regarding the exercise of voting rights by discretionary investment firms. In 1990, when discretionary investment firms entered the field of investing assets of employee pension funds and others, it was discussed which of the employee pension funds, trust banks, discretionary investment firms, etc. would exercise the voting rights. At that time, since these employee pension funds have a proxy aspect characteristic in holding public capital, there was a fear that their direct exercise of voting rights could be connected to national indirect industrial guidance, and on the other hand also, if the trust banks were to hold the authority to actually exercise voting rights, it could give rise to the possibility of putting them over the bounds of the 5% rule of the Antimonopoly Act. As a result of considering these various situations, in asset investments of employee pension funds by three-party agreement, it was decided that the discretionary investment firms shall exercise voting rights, etc. (Japan Securities Investment Advisors Association Study Group on Exercising Shareholder Rights including Voting Rights (2002), pp. 2–3).

The Japan Securities Investment Advisors Association, upon receiving this former Ministry of Finance notice, enacted on November 28, 1990 Regarding Appropriate Exercising of Voting Rights in Pension Discretionary Investment Contracts, a self-regulation rule targeting themselves, the clients of the employee pension funds. In this, the following principles were clarified for making decisions on voting rights in discretionary investment firms. (1) You shall implement instructions on voting rights only for the purpose of seeking the general benefit of the client, and you shall not implement voting rights for the purpose of seeking benefit for a third party other than the client or oneself. And, when implementing voting rights, you shall not receive any instructions from the client. (2) General benefit of the client shall mean benefit from the viewpoint of pure investment value which does not have as its purpose acquiring management rights; and the discernment of that general benefit shall be left to the person deciding on the investment. However, the aforementioned notice of the former Ministry of Finance was abolished on June 8, 1998, and thereafter there has not been any formal understanding of authorities on this matter.

4.2 The Self-Regulation Rule of the Investment Advisor Business

Exercising shareholder voting rights had been left to an agreement between the parties concerned, but debates about corporate governance from all corners and expectations by institutional investors about exercising shareholder voting rights mounted, and in April 2002 members of the Japan Securities Investment Advisors Association drew up an industry self-regulation rule that would serve as a minimum rule to follow when exercising voting rights.[19] The main contents of the self-governance rule are given below.

5. Main Forces in Exercising Shareholder Voting Rights

In modern stock-held corporations, institutional investors have been sought to bear management responsibilities. It is an obligation of theirs as fiduciary. Here, a fiduciary, as stated before, indicates a pension fund, fiduciary investment institution, and others. For pension funds and investment advisor firms as fiduciaries, their responsibilities are different than as institutional investors in stock-held corporations. This is because in contrast to pension funds being tied to the ultimate beneficiary by direct fiduciary contract, fiduciary investment institutions are tied to pension funds through a fiduciary relationship. In this section, I consider the appropriateness of these main forces in exercising shareholder voting rights, that is, the main forces in decision making.

[19] Japan Securities Investment Advisors Association Study Group on Exercising Shareholders' Rights including Voting Rights (2002), pp. 9–22.

First I shall list different ways of approaching this matter. The Pension Fund Association states,

> . . . illustrated in these kinds of standards, shareholder voting rights are considered Number 1 as a concrete method to oversee corporate operations, and for the time being these activities should be implemented through investment fiduciary institutions. When it comes to pension funds exercising voting rights under current conditions, there are procedural restrictions because clerical handling and corporate analysis abilities are underdeveloped. Therefore, investment fiduciary institutions are in actuality made solely responsible for exercising shareholder voting rights, but we recommend that concrete standards for exercising voting rights be devised using as reference observations expressed in the report.

In 2002, in-house investing began at the Pension Fund Association, and while they themselves continue to prepare a system to make decisions on exercising shareholder voting rights, they currently entrust this solely to fiduciary investment institutions.

At the Government Pension Investment Fund, they have taken the following position.

> Exercising shareholder voting rights is natural for shareholders whose goal is investment returns, but when the Fund which is a public institution exercises direct voting rights, there are fears that such actions could give rise to concerns that the country is exerting influence on private corporate operations, and so the Fund does not directly implement these but leaves the decision to private investment institutions that have been given charge of investing.

At the Pension Fund Association for Local Government Officials, since the right of instructions lies in the association, they say the following.

> Shareholder voting rights shall be exercised so the company conducts corporate operations in order to maximize shareholder returns in the long term. In cases when the Association gives out instructions on exercising these rights individually, the fiduciary shall exercise the rights according to the instructions, and in cases when it does not give out instructions on exercising these rights individually, the fiduciary shall exercise these rights according to the policies regarding exercising shareholder voting rights which the fiduciary created and the Association approved.

However, under current circumstances, they do not give out instructions individually but give out comprehensive instructions while watching how the trust institutions respond. In other words, the fiduciary institutions conduct the actual decision making.

Fiduciary institutions take part in investment activities in capital markets as professionals when exercising shareholder voting rights, and can tell if discretionary investment firms conducting management analysis of a corporation.

> . . . in cases where the policies from the client for exercising voting rights are, from the viewpoint of the professional, not appropriate, the discretionary investment firm has an obligation as an integral part of its fiduciary responsibility to confirm the fitness of the policy. By doing so, it avoids the problem of disorganized voting.

Moreover, the fiduciary institution shows a posture of positive participation by expressing its opinion.

> there are cases in which a client gives authority for voting rights by contract to a discretionary investment firm only after reserving for himself a portion of the right to instructions for exercising the voting rights. In cases in which the client's knowledge is not sufficient, and the substance for exercising voting rights that has been reserved is inappropriate from the viewpoint of the professional, the discretionary investment firm has an obligation as an integral part of its fiduciary responsibility to convey its opinion to the client (. . .) And like pension funds, in cases in which the client himself bears a fiduciary responsibility toward the ultimate beneficiary, when there is no fitness or rationality in the client's firm instructions, there is a fear that for the discretionary investment firm to follow the firm instructions in a random manner violates the spirit of its fiduciary responsibility to the ultimate beneficiary. Therefore, in these cases, the discretionary investment firm should relate its opinion to the client that it will exercise voting rights from the standpoint of the ultimate beneficiary.

As such, the main forces in Japan at present that exercise voting rights are fiduciary investment institutions. The fiduciary investment institutions themselves demonstrate a posture that they must positively respond to this issue, and this attitude reflects the movement by the Pension Fund Association after 1998 and the intentions of the practical guidelines it put forth in 2001. If we consider the actual costs created and borne in exercising voting rights such as by placing staff with full-time responsibility, etc., and the issues in increasing investment performance which correspond to that, there is not necessarily any reason for individual fiduciary investment firms to approach this topic in a positive manner. Will fiduciary investment firms, which are in a position to be subject each year or each quarter to investment analysis by their sponsors such as pension funds, be able to bear the operational responsibilities required for those stock-held corporations?

For pension funds, the significance of one aspect of asset investment is

> from a long-term perspective investing the capital of the Japanese people in sectors which contribute to the healthy development of society. By doing this, there is a connection to promoting social infrastructure improvement through capital flow into sectors which investment may seem to have forgotten in the short term and through supporting the long-term economic development of society.[20]

and the goal on an individual company level for these pension funds is

> to strive to ensure on a long-term basis comprehensive returns necessary to faithfully carry out in the future pension benefit payments to members and pensioners.[21]

A goal such as this in pension investment has investment characteristics that differ from other general investing. First is the pursuit of investment performance

[20] Yonezawa (2001), p. 3.
[21] Yonezawa (2001), p. 3.

while keeping risk in mind. Second, with the longevity of the system, investment must be of a long-term nature. High-risk investments seeking a short-term rate of return are not the only issue, but risk aversion beyond what is necessary from a short-term perspective also poses a problem. Third, since a fund's risk is tied to a parent company, management is required for the risk that is incorporated with the parent company's financial situation. And fourth, it is necessary for both the fund and the investment institution to keep in mind that they are investing the assets of a third party, the member. This is to say that it is required to provide an accounting not only of the third party's capital but also an accounting of the process used to invest that capital.[22]

For the activities that fulfill the careful obligation and faithful obligation imposed by pension funds having these special investment characteristics, a logical decision-making process has been constructed for risk-return standards. In order to manage this risk-return in a comprehensive manner, a "policy asset mix" has been created. Keeping in mind the fund's own degree of risk tolerance and investment goals, an optimal long-term policy asset mix is determined for the fund from among asset distribution options.

The investment method that faithfully represents this policy asset mix is passive investment. Since the policy asset mix is based on publicly released information, passive investment does not add a manager's own judgment into the investing. Because of that, it has the beneficial feature that investment costs such as remuneration costs and buy/sell costs as well as management costs can be eliminated.[23] In Japan, the rate of passive investment is relatively low, but with recent realignment in the manager structure, an expansion of the rate of passive investment and a movement to separate passive investment institutions is notable although slow. With the expansion of passive investment due to investment policy changes put into force at the Pension Fund Association in October 1999, many funds have recognized the merits of passive investment. There are expectations that in the future the rate of passive investment in pension fund asset investments will grow.[24]

In this way, passive investment is an important technique in pension fund asset investment, but the relationship between passive investment and exercising shareholder voting rights poses a problem. In active investment, there is the option to sell if dissatisfied with the operations of the company in which invested. However, in a passive investment, for example investment in an index which tracks a market index, one cannot sell only a portion of the companies comprising the index. As a result, in index investing, when trying to raise performance, it is necessary to raise the performance of the market as a whole.[25] That is to say, one needs to exercise a "voice" not an "exit" to make the management of a

[22] Yonezawa (2001), pp. 3–4.
[23] Yonezawa (2001), pp. 14–15.
[24] Yonezawa (2001), p. 51.
[25] Yonezawa (2001), p. 232–233.

company perform better. In U.S. pension funds, CalPERS, which is constructive in corporate governance, exercises its voting rights for this reason.

Taking into account the significance of asset investment, both long-term and passive investment techniques, pension funds themselves as a major force should move as responsible institutional investors. However, in the case of index investing, the very purpose is to parallel an index, and since the purpose is not to aim for excessive return and not to pick individual companies, research on companies is not necessary, and as a result, remuneration for investment is at bargain prices. However, when it comes to exercising voting rights, the efforts of fiduciary institutions, as stated before, incur costs for research and placing designated staff. At this point, there are almost no investment institutions that have taken on these extra investment costs, and who will bear these costs has become an issue. So, the predominant current in opinion is that exercising shareholder voting rights should be done as much as possible without incurring cost and modeled on guidelines and screening.[26]

Guidelines and screening standards are practical and effective, but there is the possibility of losing sight of the original objective (to raise investment value). In order to create value in Japanese companies while bearing only a fragment of responsibility for management, investing in corporate governance funds or creating corporate governance funds in-house is a direct measure that could be expected to have ripple effects throughout the industry while avoiding disorganized voting.

6. Conclusion

In this chapter, I have focused on shareholder voting rights by Japanese institutional investors, an area where there has been vigorous activity in recent years, examining especially the state of exercising shareholder voting rights by investment advisor firms as representatives of the Pension Fund Association, the Government Pension Investment Fund, the Pension Fund Association for Local Government Officials and fiduciary institutions. Touching upon these trends, I have considered the responsibilities of institutional investors in the stock-held corporation system.

First, the trend of pension funds (sponsors) has been to propose guidelines addressing shareholder voting rights in basic investment policies and management investment policies, and to tackle these issues in a positive manner. Yet at this stage, ultimate decision making on exercising shareholder voting rights is left up to fiduciary institutions, there are requirements that they report on the results, and there are quantitative evaluation criteria for selecting investment institutions.

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[26] Yonezawa (2001), p. 233.

Next are investment advisor firms. By publishing self-regulation rules for the investment advisor business, On Discretionary Investment Companies Exercising Shareholder Rights Including Voting Rights, they themselves have demonstrated a posture of taking a leading role in exercising shareholder voting rights.

One could think that Japan's institutional investors positively addressing the exercise of shareholder voting rights is influenced by the British and U.S. view that "voting rights are an asset, and the exercise of shareholder voting rights by institutional investors is a duty and part of the responsibilities of a fiduciary," but "creating by oneself an important factor to increase share price" is something an institutional investor must do. Increasing the share price is a basic responsibility of a corporate manager in a large company where there is a "separation between ownership and management." In modern large-scale stock-held corporations, there are occasions when corporate managers using their position as administrators of the business take action which is to the detriment of the long-term benefits of the shareholder. Staving off actions of this type of corporate manager is a new role sought in institutional investors.

Using guidelines and screening standards as a method of exercising shareholder voting rights is practical and effective, but it is in question whether this is a responsibility that can be forced upon a traditional institutional investor to carry out. In order to create value in Japanese companies while bearing only a fragment of responsibility for management, pension funds (sponsors) investing in corporate governance funds or creating corporate governance funds in-house could be expected to be a more effective method for directly exercising shareholder voting rights.

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6
Board of Directors

Nobuyuki Demise

1. Introduction

The Japanese model of the board of directors is a one-tier board system. Many large companies have a board of corporate auditors. The corporate auditors, one of whom must be from outside the company, are elected at the shareholders' meeting. The Japanese Commercial Code, revised in 2003, enables Japanese companies to introduce a board committee system and abolish the auditor system. The board committee system is composed of the audit committee, the nominating committee, and the remuneration committee, and the majority of members of each committee is made up of directors from outside the company.

This chapter presents the main features of the board of directors in large Japanese companies. The first section describes the reforming board structure and the different models of the board of directors. The second section describes aspects of those companies with a board of corporate auditors, and the third section describes those with the board committee system.

2. Different Models of Board of Directors

The Japanese model is a one-tier board system. Figure 1 shows the features of the traditional model. All directors are elected at the shareholders' meeting, and directors constitute the board. The board of directors is supposed to represent the interests of the shareholders. The board has the authority to make executive changes as they see fit. Many directors and executives in Japanese companies are former employees of those companies with many years of service.[1] The majority of the board is made up of in-house directors and also includes executive posts.

Many large companies have a board of corporate auditors, which is called *kansayakukai*. The corporate auditors are elected at the shareholders' meeting.

[1] Learmount (2002), p. 125.

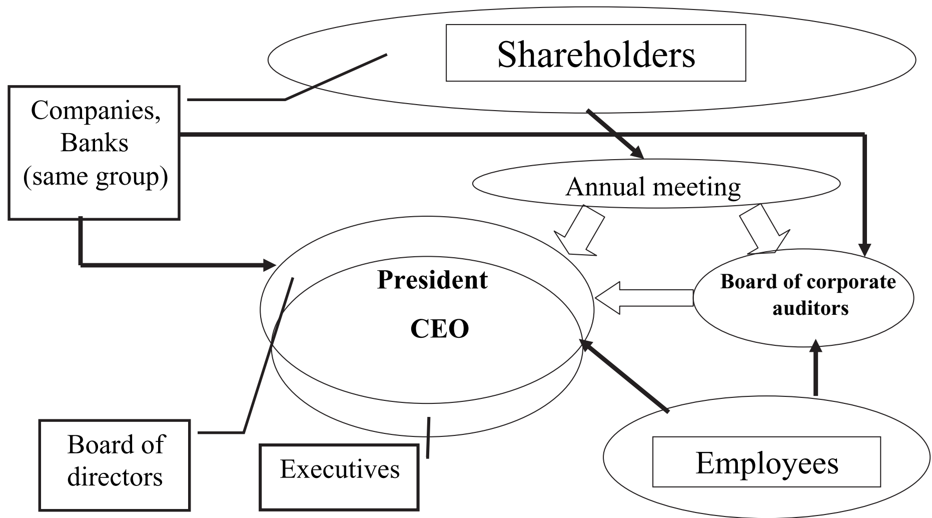

Fig. 1. Board of directors: Traditional model. *CEO*, chief executive officer

According to Japanese company law, the board of corporate auditors must monitor management and report to the shareholders' meeting. Some external directors and corporate auditors are executives of other companies. Many large companies belong to *keiretu*, the group of large companies such as the Mitsubishi companies. In these companies, external directors and corporate auditors are often chosen from other companies that belong to same group.

More specifically, a large bank, which is called the "main bank," is part of the same keiretu and owns shares of other companies that belong to the same keiretu, and is the largest creditor for those companies. When a company falls into financial crisis, the main bank does not collect debt but sends out executives and directors, whose aim is to embark on the reconstruction of the company. However, the powers of the main bank have in general diminished in Japan, since many banks fell into crisis after the collapse of the "bubble economy."

In 1997, Sony cut its board membership from 38 to 10 in a clear attempt to change the board from an honorific body to a genuine decision-making body that could offer strategic input and oversight.[2] In other words, Sony aimed to separate decision making from execution. Thirty-one directors left their post and were appointed *shikko yakuin*, corporate executive officers. At the same time, Sony increased the number of outside directors, and introduced the nominating committee and the remuneration committee.

Following this, many companies began to change the structure of their board of directors by reducing the number of directors and introducing corporate exec-

[2] Monks and Minow (2004), p. 318.

utive officers. In 1999, Hitachi reduced the number of its directors from 30 to 14 and 21 corporate executive officers. Some large companies, including Softbank, Sanyo Electric, and Orix introduced outside directors. About 40% of listed companies introduced directors from outside, but their number was only one or two in many of them. In 2001 Hoya, a famous lens maker, changed the structure of their board of directors, which was composed of three external directors and three internal directors who also held the post of executive, and introduced a remuneration committee composed only of external directors.

The Japanese Commercial Code was revised in 2003. This allowed Japanese companies to introduce a board committee system and abolish corporate auditors. The board committee system is composed of the audit committee, the nominating committee, and the remuneration committee, and the majority of each committee is made up of outside directors. Thirty-eight listed companies introduced this system in 2003 but many, including Toyota Motor, Matsushita Electric, and Canon, did not do so. Some of these sought to reform corporate governance in another way, e.g., by reducing the number of directors and introducing executive officers. Canon demand that directors stand for special divisions.

After corporate scandals were uncovered, a few companies such as Snow Brand Milk Products and Nippon Meat Packers introduced the outside director, who is in charge of business ethics and is a former member of consumer organizations. They formed an ethics committee that was chaired by an external director. The former chairperson of the committee was appointed to the post of auditor. These cases are few, however. Reform of corporate governance regimes remains an important problem.

3. Companies with Board of Corporate Auditors System

According to Nihon Kansayaku Kyokai, the Japan Corporate Auditors Association, the legal relationship between a corporate auditor and the company is entrustment.[3] The corporate auditor system existed before World War II, but the amendments to the Commercial Code in 1950 reduced the power and responsibility of auditors. The system took its current form through amendments to the code in 1974, 1981, 1993, and 2001, all of which extensively strengthened the power and independence of corporate auditors.

After the U.S.–Japan Working Group on the Structural Impediments Initiative presented their joint report in 1990, the Committee on Legislation examined the

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[3] See http://www.kansa.or.jp/english/index.html. The Japan Corporate Auditors Association is a public-service corporation established in 1974, when there were several scandals and examples of illegal activity by directors, even among major Japanese companies. Presently the Association has about 4000 corporate members and about 6000 registered corporate auditors. The principal purpose of the Association is to develop and promote the corporate auditors system. For this purpose, they investigate and study the system and the actual conditions of corporate governance among Japanese business corporations. They also present Corporate Auditors' Audit Procedures.

Commercial Code with a view toward enhancing disclosure requirement and shareholders' rights. The code was revised in 1993. Large companies, which have legal capital of ¥500 million or more or total balance-sheet liabilities of ¥20 billion or more, have a legal obligation to introduce the board of corporate auditors, which is composed of at least three corporate auditors, at least one of whom must be full-time.

The corporate auditor system is open to criticism. Certainly some corporate auditors do not obtain efficient enough information about corporate affairs. They often have few resources. Many of them are former employees of their companies but are not nominated to the post of director.

The corporate auditor system is reinforced by the Commercial Code. On its revision in 2001, the Commercial Code obliged that at least half of the members of the board of corporate auditors in large companies must be outside auditors.

According to Nihon Kansayaku Kyokai, the board of corporate auditors must be a separate body from the board of directors, and there must be a full-time auditor. Also, a corporate auditor may not serve concurrently as a director, and the code's qualifications for outside corporate auditors require even greater independence.[4] The corporate auditors owe a duty of care to the company. Under company law, the legal duty of a corporate auditor is to "audit" the activities of directors, through a business audit and a financial audit. A business audit is a check on whether or not the directors observe laws, regulations, and the company's charter provisions in managing the company, and is commonly called a compliance audit. It is generally understood that this does not include a check on the appropriateness of a director's decision making or activities, which is referred to as an appropriateness audit.

However, since the Commercial Code imposes a duty of care upon directors, a business audit must include a check on whether or not there are any breaches of this duty of care, and therefore, the corporate auditor must look at directors' business judgments from this perspective. A financial audit is an audit of financial statements and, unlike an audit required under the Securities and Exchange Law, it must be conducted before the annual shareholders' meeting. Consolidated financial statements are also subject to auditing by corporate auditors, and the result of the audit must be reported to the annual shareholders' meeting.

The corporate auditors are given various powers and legal rights in order to carry out their duties.[5] These are as follows.

— Right to obtain reports and conduct examinations
— Prevention of directors' illegal action
— Litigation between the company and its directors
— Financial audit

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[4] See http://www.kansa.or.jp/english/index.html.
[5] See http://www.kansa.or.jp/english/index.html.

These powers and legal rights of the corporate auditors are arranged in the Corporate Auditors' Audit Procedures, which is presented by Nihon Kansayaku Kyokai. They are as follows.[6]

1. Creating a structure for conducting audits
2. Determining audit policy and preparing an audit plan
3. Examining audit methods and actual process
4. Writing a corporate auditors' report, "Term-end Audit"

In (1), the procedures are related to the board of corporate auditors and cooperation with related divisions. In (3), they introduce the business audit and financial audit.

In 2005, Nihon Torisimari Kyokai, the Japan Association of Corporate Directors, presented its Best Practice Code for a corporation's board of corporate auditors.[7] Its salient points are:

1. Business judgments
2. Overseeing operations
3. Disclosure, accountability and transparency
4. Audit
5. Nomination and remuneration of directors
6. Compliance and prevention of malpractice
7. Action in deterioration of performance
8. Action for takeover bid

After the Commercial Code was revised in 2003, large companies were able to introduce the board committee system and abolish the board of corporate auditors. Presently about 100 large companies have introduced the board committee system. The remainder retains a board of corporate auditors. Therefore, Nihon Torisimari Kyokai devised the Best Practice Code for corporations with a board of corporate auditors.

On the other hand, some companies, like Toyota and Matsushita, brought about reform by reducing the number of directors while bringing in more executive officers, known as the separation of execution from decision making. Figure 2 shows these new models of corporate governance. Since 1997, about 500 companies have adopted this model. The number of directors in a company has thus become smaller, the average number now being about ten. Some companies introduced more corporate auditors from outside. These companies, including Toyota, Matsushita, and Canon, show good business results and transparency. However, many corporate scandals have been uncovered in companies with a board of corporate auditors system, including Seibu Railway, Kanebo, and Mitsubishi Motors.

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[6] See http://www.kansa.or.jp/english/index.html.

[7] http://www.jacd.jp/report/050801_01report.pdf. Nihon Torisimari Kyokai established in 2002 to introduce outside directors.

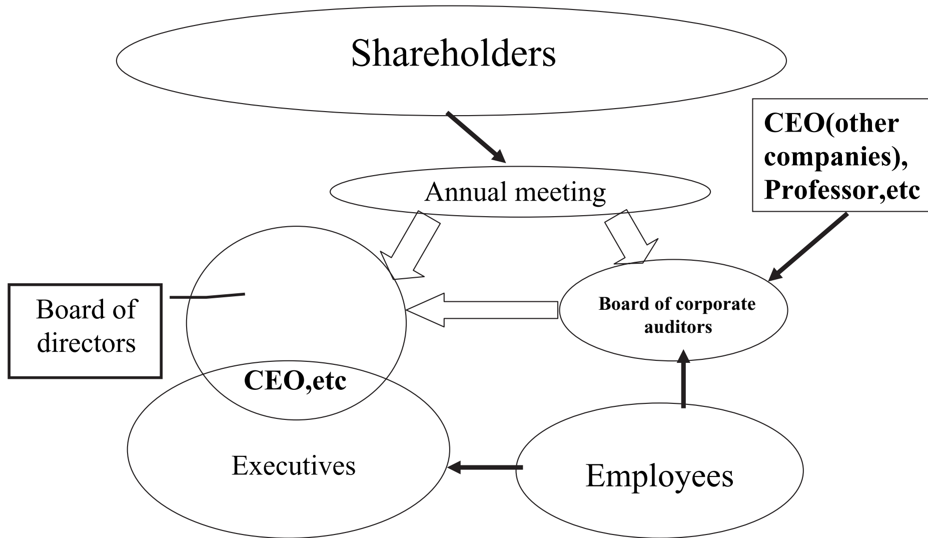

Fig. 2. Companies with a board of corporate auditors

4. Companies with a Board Committee System

In 1973 in the United States, NYSE (the New York Stock Exchange) requested of listed corporations that their audit committee included more than three external directors. ALI (the American Law Institute) presented the Principles of Corporate Governance and Structure in 1982. They recommended that corporations introduce the audit committee, the nominating committee, and the remuneration committee. Presently most large corporations have a board committee system and an audit committee. In the United States, the audit committee is required by law to be composed entirely of external directors.[8]

In the United Kingdom, the Cadbury Committee (on the Financial Aspects of Corporate Governance) was established in 1991. It presented a Code of Best Practice in 1992. In the code it was recommended that companies introduce the audit committee, the nominating committee, and the remuneration committee. As a result many public companies introduced the board committee system.

Figure 3 shows another new model of the Japanese board system. The Japanese Commercial Code revised in 2003 enables Japanese companies to introduce the board committee system and abolish the corporate auditor system. The board committee system is composed of the audit committee, the nominating committee, and the remuneration committee, and the majority of members of each committee are directors from outside the company. Presently, about 100

[8] Lawrence et al. (2005), p. 295.

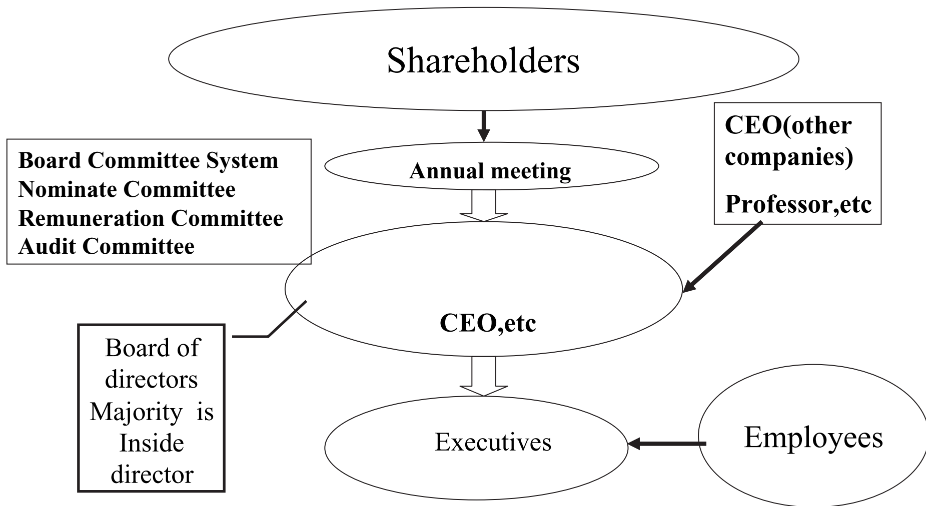

Fig. 3. Companies with a board committee system

companies, including Sony, Toshiba, and Hitachi, have adopted this model. This system promotes the separation of execution from supervision.

Sony aimed to enhance their group's corporate governance functions by improving management transparency of the group through boosting the role of the board as a monitoring body as well as clarifying executive responsibility and additional transfer of authority. Toshiba adopted the board committee system for the purpose of reinforcing supervisory functions and management transparency, and improving operating agility and flexibility. Hitachi aimed to improve the speed of management, to secure more transparent management practices, in order to serve as part of the group companies' management strategy and improve global management.

The shareholders in companies with the board committee system do not have the right of electing corporate auditors and nominating candidates for directorship. Some companies shifted to the new system under the leadership of a top manager. The effectiveness of the board committee system must be examined, because corporate governance regimes are related to the monitoring of a top manager.

5. Conclusion

Some companies change the structure of the board of directors, as foreign investors increase their share ownership. After the exposure of malpractice, many companies tend to shift the focus onto reformed corporate governance. Companies may bring in directors from outside to manage the ethics committee.

They take charge of the ethics communication systems and the ethics training programs. About 100 large companies have introduced the board committee system since the Commercial Code was revised in 2003. However, many companies have shifted to the new system under the leadership of a top manager rather than outside stakeholders. Many Japanese top managers follow the fashion of the management style. Many external directors are corporate executives in other companies or persons who have resigned their post. Certainly those external directors have knowledge and experience of business, but it is not clear whether those directors are superior to others. Both the effectiveness of external directors and the effectiveness of the board committee system must be examined further.

According to Yoshimori, the board structure is important for corporate success and corporate values; culture and strategy are equally vital ingredients of corporate success.[9] Therefore, top managers must cope with both the corporate governance problem and corporate philosophy including corporate values, culture, and strategy.

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[9] Yoshimori (2005).

7 Accounting and Disclosure in Japan

Yoko Nakoshi

1. Introduction

In this chapter I consider accounting and disclosure in Japan. I first explain the setting of the accounting standard in Japan, focusing on how this standard differs from international accounting standards and United States standards. I discuss to what extent the Japanese standard is original and how far it is approaching an international convergence following increased funding from overseas institutional investors.

Further, I focus on disclosure in Japan related to corporate governance, in particular, the disclosure of directors' remuneration and the audit fee. Since the legislation of the Sarbanes–Oxley Act in the United States, the volume of the brief earnings announcement of the most recent financial statement and Prospectus and Securities Report in Japan has rapidly expanded, and the contents of disclosure documents are gradually approaching similarity to those of Europe and the United States.

2. Difference Between Current International Accounting Standards and Japanese Accounting Standards

2.1 Accounting Standards in Japan

As regards accounting standards in Japan, the Commercial Code, Securities and Exchange Law, and the Opinion Book on Business Accounting Council have existed for a long time. The Commercial Code and Securities and Exchange Law are compulsory, and the accounting standards have been set by the Business Accounting Council under the control authority. All accounting rules have been set by public sector bodies.

However, to follow the organizational reform suggested by the International Accounting Standard Board (IASB), it would have to fulfill the condition that "accounting standard setting organizations should be private sectors that have a full-time staff," were Japan to be influenced internationally concerning account-

ing standards. Thus, a private Financial Accounting Standard Foundation (FASF) was established, and the Accounting Standard Board of Japan (ASBJ) was set up within FASF. Some accounting standards have already been announced by the ASBJ. Setting of accounting standards by the private sector was introduced by way of the FASB (Financial Accounting Standard Board) in the United States, and due process has been introduced.

Accounting standards are therefore set in Japan by the Business Accounting Council, which is a public sector body, and the Accounting Standard Board of Japan, which is part of the private sector. However, Japanese accounting standards have some points that differ from international and United States standards, and it is for this reason that overseas investors might not correctly evaluate Japanese enterprises. Actually, it is thought that overseas standards are not necessarily correct from the standpoint of accounting theory, and Japanese original standards still exist although the difference between overseas accounting standards and Japanese ones has decreased. For example, accounting for business combinations has been clarified. Let us examine this point in more detail.

2.2 Accounting for Business Combinations in Japan[1]

2.2.1 Distinction of a Company That is Acquired with an Acquiring Company

In the combination of enterprises, cash is delivered to buy the stocks from the stockholders of the company that is acquired, or stocks of the acquiring company are delivered. The former is a cash purchase and the latter is a stock transaction. Then, how can we judge the distinction between the company that is acquired and the acquiring company?

In Japan it is presumed that there are cases where we can distinguish the company that is acquired from the acquiring company or not in the combination of enterprises. Because a lot of business combinations seem to take place in order to control other enterprises under the management strategy, it should pertain that the distinction of the acquiring from acquired company is easily made. The United States accounting standards and international accounting standards also take this standpoint.[2]

However, the combination of enterprises comes about without a clear ruling as planned by "uniting the shares" in which the holding company is established by the transaction of the stocks, as with Mizuho Holdings. In that case, the economic substance comprises uniting the shares by the companies that participated. After they unite, they are assumed not to change. So we cannot distinguish the company that is acquired from the acquiring company.

[1] See Business Accounting Council (2003).
[2] See FASB (2001a) and IASB (2004).

In the case of establishing Mizuho Holdings, it was argued that the values of the stocks of three companies (Industrial Bank of Japan, Fuji Bank, and Daiichi Kangyo Bank) were the same because the ratio when the stocks were moved remained the same.[3]

However, in the case of establishing the holding company by moving stocks, sometimes we can distinguish the company that is acquired from the acquiring company. In 2001 Nippon Paper Industries. Co. Ltd. and Daishowa Paper Mfg. established the holding company Nippon Unipac for the purpose of integration. In the combination, one stock of Nippon Unipac was exchanged for Nippon Paper Industries stocks 0.0010 and Daishowa Paper 0.0006 according to the ratio when the stocks were exchanged.[4] The value of the stock of Nippon Paper Industries was higher than Daishowa Paper at the time. Therefore, it was judged that Nippon Paper Industries was an acquiring company.

Thus in distinguishing the acquiring company, the stock exchange ratio becomes the main element.

2.2.2 Pooling-of-Interest Method Versus Purchase Method

How does accounting treat what occurs? Here, I wish to focus on the method of evaluating the assets and liabilities.

If it is impossible to distinguish the company that is acquired from the acquiring company, the business combination is presumed to unite shares of the participating company, and all assets and liabilities are succeeded at the book value. Moreover, the retained earnings are succeeded as they are. This is called the "pooling-of-interest" method, which in fact was applied in the case of Mizuho.

On the other hand, if it is possible to distinguish the company that is acquired from the acquiring company, the assets and liabilities of the company that is acquired are evaluated at fair value, such as the market value, and the acquiring company writes this up in consolidation. This is called the purchase method. Here, it can be argued that economic substance after the integration changes because the assets and liabilities of the company that is acquired are evaluated at fair value. In the case of Nippon Unipac, the purchase method was applied.

In Japan, both of these accounting methods are permitted in business combination practice.[5]

2.2.3 Accounting for Business Combinations—FASB and IASB

In the past, in international and U.S. accounting standards, both the aforementioned purchase and pooling-of-interest methods were allowed only to some extent, and application of the latter method was permitted only under extremely

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[3] See the Prospectus and Securities Report of Mizuho.
[4] See the Prospectus and Securities Report of Nippon Unipac. In 2004 Nippon Unipac changed its name to Nippon Paper Group, Inc.
[5] See Business Accounting Council (2003).

limited conditions.[6] This also applied in Japan. However, today only the purchase method is permissible in business combination through alteration of the accounting standards, and the pooling-of-interest method is prohibited in the U.S. and international accounting standards.[7]

Additionally, in the application of the purchase method, how the goodwill should be amortized differs between Japan and the United States.[8] However, let us focus here on the application of the pooling-of-interest method.

2.2.4 Discussion on Pooling-of-Interest Method

When application of the pooling-of-interest method is permitted in Japan, the business combination in which it is impossible to distinguish the company that is acquired from the acquiring company assumes the economic substance to be unchanged before and after the business combination. Under the pooling-of-interest method the amortization cost is zero because evaluation of the succeeded assets is not done and goodwill is not generated. There is also an advantage that the retained earnings of the company that is acquired can be succeeded.

In the United States, on the other hand, gaining such an advantage using the pooling-of-interest method would be prohibited from a critical standpoint. It is argued that basically it is necessary to evaluate the assets succeeded by the business combination at fair value.

In the attempt to reach convergence of international accounting standards, the admission of the pooling-of-interest method in Japan remains a sticking point.

2.2.5 Response of Japan in Organizing Convergence of Global Standards

Japan explains the application of the pooling-of-interest method from the standpoint of accounting theory research.

Excluding the business combination, there are few points under discussion greatly different from international and U.S. accounting standards. Accounting for the impairment of assets taken up follows the United States standard,[9] as does accounting for stock options.[10]

Regarding business combination and the admission of an original Japanese accounting standard, in short, the pooling-of-interest method has a negative effect on the securities market, because the business combination frequently involves international dealings and negotiation with overseas investors. In the United States and European countries, the accounting method for the business combinations that many investors demand is the purchase method, even if the pooling-of-interest method is permitted from a theoretical accounting standpoint.

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[6] See APB (1970) and IASC (1998).
[7] See FASB (2001a) and IASB (2004).
[8] See FASB (2001b).
[9] See Business Accounting Council (2002).
[10] See ASBJ (2004).

Since the Sarbanes–Oxley Act in the United States was enacted, disclosure concerning corporate governance in Japan has been widened. The overseas securities market must be considered as important at the disclosure level, though it is not complete. Having described the situation in Japan concerning the original accounting standard on business combination, I now examine the current state of disclosure.

3. The Influence of the Sarbanes–Oxley Act on Japan

3.1 Disclosure Concerning Corporate Governance in the Brief Announcement of the Most Recent Financial Statement

In the brief announcement of the most recent financial statement following the end of the fiscal year submitted to the Tokyo Stock Exchange, the item concerning corporate governance was disclosed. This is called the "Basic idea concerning corporate governance and execution condition."

The organization of management that is related to the mechanism of decision making in the company, the execution, and the supervision is reflected concretely in the figures. The distinction of whether there is a board committee system or an auditor system is stated. In addition, the election situation of external directors and external auditors, human relations, capital relations, the relations between dealings, and other interests are explained. Moreover, the mechanism of the operating audit, the accounting audit, and the internal audit is set out in detail.

The disclosure of the remuneration is divided into that of directors and auditors. Here, the total of the directors' remuneration is shown, and the number of directors is disclosed. There is no distinction given here between external and internal directors.

3.2 Disclosure Concerning Corporate Governance in the Prospectus and Securities Report under the Japanese Securities and Exchange Law

Recently, new items have been obligated to be included in the Prospectus and Securities Report under the Japanese Securities and Exchange Law. The item concerning corporate governance is "Situation of the corporate governance." Additionally, there are two items, "Risk of the business" and "Analysis of the financial position and the management result" relating to information concerning corporate governance.

These trends arise from the influence of the U.S. Sarbans–Oxley Act that was legislated against the background of the scandal (including illegal accounting) of various enterprises and the Enron failure. In Japanese disclosure documents there now exists the heading "Situation of the corporate governance." Let us examine this item in detail.

3.2.1 Board Committee System

"Situation of the corporate governance" in the Prospectus and Securities Report on a board committee system company is set out as follows.

Strengthening the supervisory function of management is explained as well as the brief announcement of the most recent financial statements. The supervision, the audit, the compensation decision, etc., are described. Managing boards of various committees (the nominating committee, the audit committee, and the remuneration committee) are explained in the figures.

It is argued that strengthening and enhancement of the internal management system will be achieved, to improve the influence of the audit by the audit committee in the explanation. This system ensures that monitoring by the audit committee is efficiently executed, and this is described as strengthening the corporate governance.

In addition, the in-house and outside directors are distinguished, and the separate classification of in-house and outside is used when disclosing the directors' remuneration and the audit fee. Concretely, it is displayed as in-house directors, outside directors, and corporate executive officers. The remuneration of those who serve concurrently as director and corporate executive officer is disclosed in the section concerning the latter.

At present in Japan, the number of the directors and the total amount of the remuneration are disclosed in the classification of in-house and outside. This differs from the United States and some European countries where the directors' remunerations are disclosed individually.[11]

For the enterprises included in the overseas listing, especially in the United States, the membership of the audit committee must fill the independent directors' requirement as based on the Sarbanes–Oxley Act.

On the other hand, fees, either from the audit or those other than the audit (for example tax consulting and M&A consulting are distinguished and disclosed among all payments to the accounting office, which now takes charge of the audit. In addition, the relation with the accounting office that takes charge of the audit is described in detail.

3.2.2 Auditor System

"Situation of the corporate governance" in the Prospectus and Securities Report of an auditor system adoption company contains the following.

A polite explanation is given about the situation of the approach to corporate governance. An explanation of the organization of management that is related to the decision-making, the execution, and the supervision within company management is given, even though it does not adopt the board committee system.

Especially similar to the board committee system is that while adopting the auditor system, some companies set up various committees to act as the advisory panel to the managing board. For instance, for Mitsui & Co., the governance com-

[11] See Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe (2004).

mittee, the nominating committee, and the remuneration committee are active. Moreover, because the board committee system is not adopted, these committee members are made up of both in-house and outside directors. However, for Mitsui & Co. the outside director also works as chairman of the remuneration committee.

An adequate description is made of the outside director's election, and whether he or she is independent is discussed though the auditor system is adopted. In particular, for Mitsui & Co. the internal management system was introduced after the legislation of the Sarbanes–Oxley Act in the United States. There are five committees (internal management committee, compliance committee, disclosure committee, crisis task force, and CSR promotion committee) that are related to business execution.

In the disclosure of remuneration, the outside and in-house directors are not distinguished, although the directors' remuneration and the auditor fee are reported separately. This is regarded as the main difference between the board committee system company and the audit system company. The total amount of remuneration and the number of directors are disclosed regardless of outside or in-house.

The audit fee is divided into those from auditing on business, on business related to the audit, tax consulting, and others (M&A consulting), much as in the board committee company. Additionally the relationship with the accounting office is specified.

3.3 Other Disclosure Items in the Prospectus and Securities Report

As mentioned above, it is "Risk of the business" and "Analysis of the financial position and the management result" that are new reporting obligations concerning corporate governance. These items explain the possibility of a bad influence being exerted on a business and of sufferance of any loss. Moreover, it can be argued that they explain the content written in the note to financial statements in detail.

The expansion of disclosure in the Prospectus and Securities Report is not paralleled by a change in the accounting standards. However, accounting information for investors is sure to increase and to influence the securities market. Additionally, by the enactment of the Sarbanes–Oxley Act, detailed disclosure is compulsory when listing in an overseas list, especially in the United States. The expansion of disclosure in the Prospectus and Securities Report in the securities market in Japan appears to be a positive trend toward introducing an idea similar to that in the United States.

4. Conclusion

In this chapter I have explained the setting of the accounting standards in Japan. Differences between the Japanese standards and those of the United States and

internationally were given special attention, because the difference in overseas accounting standards becomes a problem when funding in Japan is obtained from overseas investors.

The Japanese accounting for business combinations has permitted the pooling-of-interest method, although working toward international convergence is being done to reduce the differences in accounting standards in every country. It might be proposed that Japanese enterprises apply the purchase method in business combinations. In the United States the stockholders' proposal was included in the accounting for the stock option. There remains the difficulty of the coexistence of accounting theory and the idea of considering the stockholders' proposal as important.

In Japan, disclosure related to corporate governance is continuously required by the rules of listed companies of the Tokyo Stock Exchange and Securities and Exchange Law. I explained mainly the disclosure of management remuneration.

Management remuneration is disclosed individually in the United States and some countries in Europe, but not in Japan where, in the case of a board committee system company, the in-hourse and outside directors are distinguished in the disclosure of remuneration. The audit fees are divided into those from auditing on business, on business related to the audit, on taxation accounting, and others.

The investors request the individual disclosure of management remuneration, though Japanese companies have disclosed more accounting information in response to an overseas listing. In fact the stockholders' proposal to request individual disclosure of management remuneration was made to Sony, but was voted down.

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8
Managerial Judgment Hazard in Corporate Governance

Mariko Nakabayashi

1. Introduction

There is an increasing recognition of the fact that directors' moral hazards in decision making can cause huge financial losses and as a result, undermine the corporation's financial stability. On the other hand, the term managerial judgment hazard refers to unintentional failures in decision making by directors. Directors can make mistakes even when they make decisions in good faith, believing that these decisions will benefit the corporation.

Such unintentionally failed decisions can cause financial losses to corporations, give rise to lawsuits against them, and lead to potential legal liability. Under modern corporate law and practice, directors must monitor or oversee the conduction of the corporation's operational activities.[1] Directors' decision-making is one of the indispensable roles for corporations to remain a going concern; therefore, managerial judgment hazard is regarded as one of the major hazards that corporations have to deal with in view of risk management.

This chapter aims to contribute to understanding of managerial judgment hazard, specifically concerning directors' decision making in publicly held corporations in Japan. Further, it presents means by which this issue can be dealt with.[2] Managerial judgment hazard is an important issue in corporate governance. First, I plan to review the conceptual framework of managerial judgment hazard in order to identify directors' failed decisions that cause and increase losses of corporations and define the notion of "directors' reasonable decision." The business-judgment rule in corporate law is a specific application of the directorial standard of conduct. Hence, I will examine Eisenberg (1993), based on which the Model Corporate Act of 1998 has formulated a clear statement for the business-judgment rule. Second, I will attempt to determine a standard for reasonable decisions by directors. To delve into directors' accountability, it is necessary to establish an ethical standard that guarantees a higher standard of

[1] Eisenberg (1993), p. 439.
[2] In this chapter, I have assumed that the director is an internal director.

performance than is currently required by law. Carroll's four-part definition of corporate social responsibility (CSR) is helpful in describing this standard.

Finally, I will highlight examples of directors' failed decisions in the Japanese voluntary automobile insurance market to examine whether managerial judgment hazards cause and/or increase losses, and provide an effective means to deal with this issue.

2. Managerial Judgment Hazard

2.1 Key Points of Managerial Judgment Hazard

Tuan (1972) broke new ground in studies on hazards and classified hazards relating to human behavior in the insurance market into three categories: moral hazards, morale hazards, and human error hazards. Human error hazards pertain to unintentionally failed decisions that are caused by "human nature."[3] Morimiya (1985) followed Tuan's classification and redefined the human error hazard as managerial judgment hazard in view of risk management. Managerial judgment hazard refers to unintentional failures in decision making that increase the frequency or severity of loss. Personal feelings and/or a failure to recognize problems due to incompetence could cause failed decisions.[4]

Figure 1 presents the conceptual framework of hazards relating to human behavior. These are classified into personal hazards and human hazards. Personal hazards are caused by an individual's personal behavior; hence, these can generally be controlled by the persons themselves. Human hazards are caused by a person's criminal or grossly negligent acts concerning impersonal behavior or social moral norms; therefore, it is difficult for these to be controlled by the persons themselves.[5] Among personal hazards, unintentionally failed decisions are called managerial judgment hazards.[6]

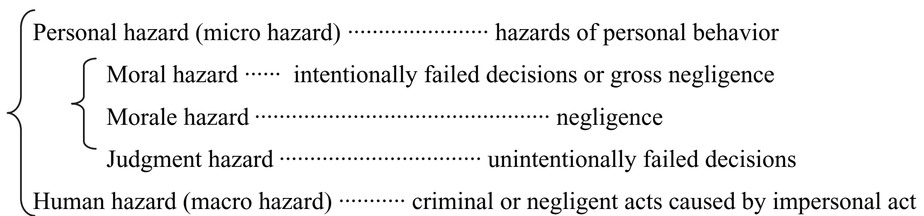

Fig. 1. Conceptual framework for hazards relating to human behavior

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[3] Tuan (1972), pp. 157, 159.
[4] Morimiya (1999), p. 24.
[5] Morimiya (1985) classifies hazards in view of risk management into two types. One is generally controlled by the organization itself, while the other is not. He calls the former a "micro hazard" and the latter a "macro hazard" [Morimiya (1985), pp. 23–28].
[6] Nakabayashi (2003), p. 22.

2.2 Managerial Judgment Hazard of Directors

To examine the managerial judgment hazard of corporate directors, it is necessary to define the notion of "directors' unintentional failed decisions." Directors owe fiduciary duties to the corporation they serve and its stockholders.[7] These fiduciary duties include the duties of care and loyalty, which today form the bedrock of corporate governance law.[8]

Directors need to be liable for their fiduciary duties.[9] In case they do not attempt to fulfill their fiduciary obligations, their failed decisions should be regarded as gross negligence, even if these are caused unintentionally. Therefore, in the case directors make failed decisions according to the criteria of fulfilling directors' fiduciary obligations, their decisions are regarded as being managerial judgment hazards.

2.3 The Threats from Managerial Judgment Hazards to Corporations

Directors' failed decisions can cause losses to corporations, give rise to lawsuits against them, and lead to potential legal liability. In cases where the courts judge that directors have made failed decisions, intentionally or by gross negligence, they have to be made liable for their failed decisions. As a result, corporations' losses are partly relieved by the directors themselves. On the other hand, if the courts judge that their failed decisions were unintentional, that is, the losses caused by managerial judgment hazards, they are granted injunctive relief and the losses remain the corporations' responsibilities under the business-judgment rule. This implies that managerial judgment hazards can cause huge losses to corporations. Figure 2 shows the effects of directors' failed decisions.

Although the frequency of managerial judgment hazards is high, they can at least be partially controlled. To deal with these, directors should first identify the criteria for their failed decisions. The general standard of conduct for directors is codified in corporate law. The business-judgment rule in corporate law grants injunctive relief, and is helpful in examining the criteria for directors' decisions. It is essential to study the American Model Business Corporation Act, because most states in the United States have codified the general standard of conduct for directors in their corporate laws, and Japan is planning to follow them by also doing so.

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[7] In the simplest terms, the duty of care requires that directors exercise their responsibilities under similar circumstances, and the duty of loyalty prohibits self-dealing [Block et al. (1998), p. 1].

[8] Block et al. (1998), p. 1. Under the Japanese Commercial Code, there exists a proxy condition in the civil law between corporations and their directors. In this context, directors have the duties of care and loyalty [Kondo (1996), p. 5].

[9] They also have a non-fiduciary moral obligation to those affected by their actions, that is, to the stakeholders [Carroll (2001), p. 35; Freeman and Reed (1983), p. 91].

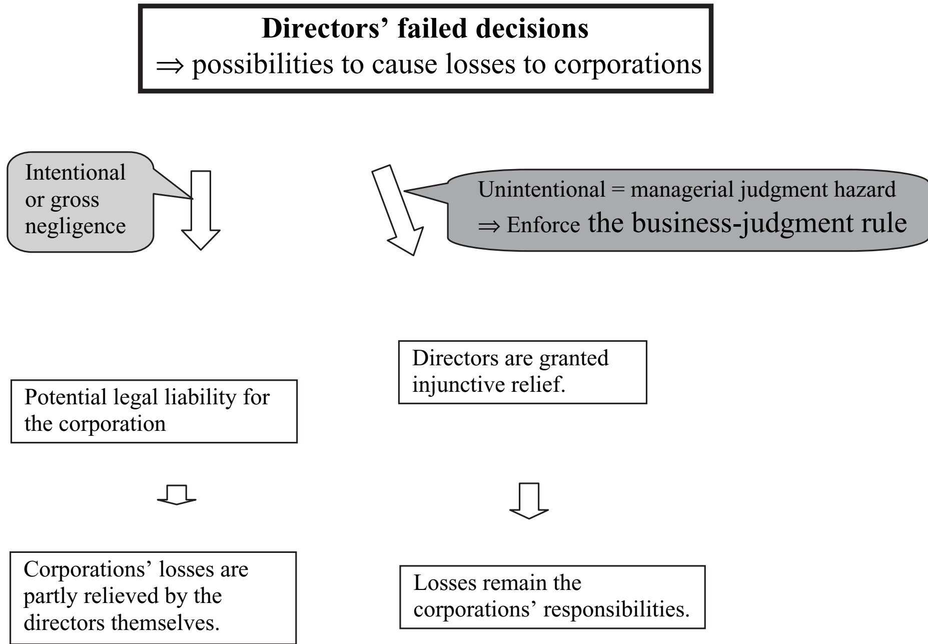

Fig. 2. The effects of managerial judgment hazards on corporations

Therefore, in the following sections, I will build up my argument on the basis of the business-judgment rule, while considering the differences between American and Japanese courts.

3. The Relationship Between the Business-Judgment Rule and Managerial Judgment Hazard

3.1 The Business-Judgment Rule

Although the law should not discourage directors from making bold decisions, it should encourage them to pay attention to their duties. The business-judgment rule is a specific application of the directorial standard of conduct to a situation in which a business decision is made by disinterested and independent directors on an informed basis and with good faith, that the decision will benefit the corporation. In this case, the court will not second-guess the merits of that decision. For over one and—a half centuries, the business-judgment rule has been the primary means by which courts have reviewed decisions by corporate directors concerning ordinary day-to-day business decisions in the United States.[10]

[10] Block et al. (1998).

This rule applies both in actions seeking to impose liability for monetary damages upon directors for their decisions as well as in actions seeking injunctive relief against particular board actions. However, views on the meaning and elements of the business-judgment rule are not always in accordance.

Although there is no provision of the business-judgment rule under the current rules of Japan's Commercial Code, its application in Japanese courts has been increasing.[11] In the following sections, I will examine Eisenberg (1993) in order to identify a standard for "directors' reasonable decision."

3.2 A Standard for "Directors' Reasonable Decision"

3.2.1 The Business-Judgment Rule

The general standard of conduct applicable to directors and officers regarding the performance of their functions is set forth in section 4.01 of the American Law Institute's Principles of Corporate Governance: Analysis and Recommendation[12] in 1994.

A director or officer has a duty to the corporation to perform the director's or officer's functions in good faith, in a manner that he or she reasonably be expected to exercise in a like position and under similar circumstances. Eisenberg (1993) maintains that a standard of conduct states how an actor should conduct a given activity or play a given role. A standard of review stipulates the test that a court should apply when it reviews an actor's conduct to determine whether to impose liability or grant injunctive relief. In a world in which information is perfect, these would always be identical, and the risk of liability for assuming a given corporate role would always be commensurate with the incentives for assuming that role. In addition, institutional considerations would never require the defense of a corporate organ. In the real world, however, these conditions seldom hold, and the standards of review in corporate law pervasively diverge from the standards of conduct.[13]

Eisenberg presents the four conditions that are required for the application of the business-judgment rule. If these conditions are satisfied, then directors are granted injunctive relief. The four conditions are as follows:[14]

[11] American courts examine the directors' decisions only to verify (1) disinterestedness and independence and (2) that the decision was made in reasonable manner. On the other hand, Japanese courts also examine the rationality of the details of their decisions [Egashira (2001) p. 326].

[12] This document examines the problems with managing a corporation within the existing laws, and it recommends how laws and practices should be established.

[13] Eisenberg (1993), pp. 437–438.

[14] Eisenberg (1993), p. 441. The Model Corporate Act of 1998 formulated a clear statement of the business-judgment rule, based on the explanation developed by Eisenberg (1993).

1. A judgment must have been made.[15]
2. The director or officer must have informed himself with respect to the business judgment to the extent he reasonably believes appropriate under the circumstances.
3. The decision must have been made in subjective good faith.
4. The director or officer may not have a financial interest in the subject matter of the decision.

Eisenberg's conclusion is useful for an in-depth consideration of the requirements of directors' reasonable decision.

> Directors and officers may be held accountable, if not even liable, for failure to meet the relevant standard of conduct."[16]

This implies that the standard of review is not sufficient to hold directors accountable. It is necessary to establish an ethical standard that guarantees a higher standard of performance than is currently required by law in view of risk management.[17] To examine this higher standard of performance, I will focus on the requirements of directors' ethical responsibilities in Carroll's definition of corporate social responsibility (CSR).

3.2.2 Corporate Social Responsibility and Reasonable Decisions by Directors

Carroll's four-part definition of CSR helps us understand its components:

> The social responsibility of business encompasses the economic, legal, ethical, and discretionary (philanthropic) expectations that society has of organizations at a given point in time."[18]

Carroll incorporates his four-part categorization into a "pyramid of corporate social responsibility."[19] On the first level are the economic responsibilities of businesses, since a business should be an institution whose orientation is to produce goods and services that society wants and to sell them at fair prices. On the second level, businesses are expected to operate under laws. On the third level are businesses' ethical responsibilities. Laws are important, yet inadequate; therefore, ethical responsibilities embrace those activities and practices that are expected or prohibited by societal members even though they are not codified into laws. Law is a floor on behavior; it acts as a minimum requirement above

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[15] Although not making a judgment is an alternative for directors as a risk management technique, they are granted injunctive relief for their decisions because of the first condition listed above.
[16] Eisenberg (1993), pp. 467–468.
[17] Some corporate law doctrines, such as the ALI's Principles of Corporate Governance, explicitly take ethical considerations into account [Eisenberg (1999), p. 1265].
[18] Carroll and Buchholtz (2003), p. 36.
[19] Carroll and Buchholtz (2003), pp. 35–39.

which businesses must operate. On the fourth level are businesses' voluntary/discretionary or philanthropic responsibilities. Ethical responsibilities are embracing and reflect newly emerging values and norms that society expects a business to satisfy.

In order to be ethically responsible, corporations are also required to fulfill certain economic and legal responsibilities. That is, corporations are obligated to maximize profits within the boundaries of the law.[20] Therefore, directors of publicly held corporations should make decisions that are motivated simultaneously by the bottom line, the legal system, and ethical principles.[21] The standard of review in the business-judgment rule includes the legal requirements of decision making by directors; therefore, it is helpful in defining a minimum standard for directors' conduct.

4. Managerial Judgment Hazard in Corporate Governance

4.1 Corporate Scandals and Personal Hazards in Japan

Since the late 1990s, several instances of scandals and criminal behavior involving Japanese corporations have been revealed, and these have caused huge losses. Accordingly, directors' personal hazards in decision making have become one of the major issues for corporations to deal with.[22] There are three types of directors' personal hazards. First, directors make decisions based only on their own interests. In cases where they have a financial interest in the subject matter of the decision, their managerial moral hazards cause scandals.

One example is this of Sogo, one of the largest department stores in Japan. In July 2000, 22 of its group's companies filed for bankruptcy protection from

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[20] Schwartz and Carroll (2003) highlight two disadvantages of Carroll's four-part model. First, some misunderstand the pyramid framework to be representative of a hierarchical relationship among the CSR domains. Second, the pyramid framework cannot fully capture the overlapping nature of the CSR domains (p. 505). Extrapolating from Carroll's model, Schwartz and Carroll proposed an alternative approach to conceptualize CSR—a three-domain model. The three-domain approach is presented with three core domains of economic, legal, and ethical responsibilities depicted in a Venn model framework. The Venn framework yields seven CSR categories resulting from an overlap of the three core domains. The model creates a definition and overlapping segments that may be further explored. This model aids in superior classification of corporate activities and highlights issues that directors face while making decisions.

[21] Schwartz and Carroll (2003) pp. 518–519. This activity conforms to Carroll's "moral management," according to which a management desires "profitability, but only within the confines of obeying the law and being sensitive to ethical standards" [Carroll and Buchholtz (2003), p. 181]. It also conforms to Lynn Sharp Paine's "integrity strategy" (Paine, 1994).

[22] Derivative lawsuits against directors are one of the measures for stockholders to deal with these personal hazards. Specifically, since 1993, the conditions to institute a derivative lawsuit were relaxed by a Commercial Code revision. As a result, derivative lawsuits against directors have become more common.

creditors under the Civil Rehabilitation Law with the Tokyo District Court. Since the 1960s, Sogo had been consecutively establishing new stores in district capitals of Japan and other Asian countries and had fallen into a negative net worth. According to a survey of Teikoku Data Bank, Sogo was carrying about ¥247 billion in interest-bearing debt in March 2000. Since its directors, specifically the president, had a financial interest in the decisions of its expansion strategy, their decisions are moral hazards.

Directors in Japanese corporations tend to insist that they make decisions in the interest of the corporation; however, in reality, they may have a financial and/or non-financial interest in the subject matter of the decision. Further, decisions that are made to conceal the occurrence of scandals are the result of this type of moral hazard. The president of the Industrial Bank of Japan, Sogo's main lender, provided the following evidence at the finance committee of The House of Representatives held in July 2000. Although the directors of the Industrial Bank of Japan had known of Sogo's negative net worth in 1994, they continued lending to Sogo.[23] This decision by the directors is a moral hazard.

Second, in the case of directors make decisions without being completely informed, their decisions are regarded as moral hazards resulting from gross negligence. Third are managerial judgment hazards; that is, although directors make decisions in a reasonable manner, they unintentionally make failed decisions and cause losses to the corporation. The world is presently evolving more rapidly than ever before, and directors who do not keep up with this progress often make such unintentionally failed decisions.[24]

4.2 Managerial Judgment Hazard with Low Price Policy in the Japanese Automobile Insurance Market

In the following sections, I will highlight the Japanese voluntary automobile insurance market[25] to look into whether directors' failed decisions are relevant. I will review sales policy of several insurers to examine whether managerial judgment hazards cause and/or increase losses.

The Japanese Insurance Business Law of 1939 was substantially revised in 1995 for the first time in 50 years and was enforced from April 1996. To promote price and product competition, the new law introduced a notification system for certain products and premium rates. Even though the Japanese insurance market remained stringently regulated, both domestic and foreign capital companies have reconsidered their sales policy. That is, they have begun to make decisions in the Japanese automobile insurance market regarding it as a part of global market.

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[23] Arimori (2003), pp. 207–208.

[24] For example, Xerox's directors failed to identify the market for small copiers and handed that market to Canon (*Executive Focus*, March 2004, p. 15).

[25] There are two types of automobile insurance in Japan: voluntary and compulsory.

4.2.1 Trends in the Japanese Automobile Insurance Market

4.2.1.1 The Market Structure

After the United States, Japan is the world's second largest non-life insurance market.[26] As of April 1, 2005,[27] there were 26 domestic and 22 foreign insurers in the market. Thirty domestic insurers controlled 95.6% of the market in fiscal 2001.[28] Under stringent regulation,[29] Japanese domestic insurers had enjoyed a stable and profitable market environment. The Insurance Business Law of 1996 became effective in April 1996, and the U.S.–Japanese insurance-related trade talks were concluded in December. Accordingly, the Japanese market has been deregulated.[30] Specifically, since a legal obligation for the insurers to observe the premium rates set by the rating organizations on the lines of fire, personal accidents, and voluntary automobile insurance was abolished as of July 1998, competition to provide lower rates has continued. According to the General Insurance Association of Japan, the direct general premium of voluntary automobile insurance, the largest line in the Japanese non-life industry since 1964, fell 3.2% in fiscal 1998. The negative growth of net premium income of automobile insurance continued from fiscal 2001. In fiscal 2003, although the net premium income of the top six companies increased by 1.1% as a whole, it fell 1.6% on the line of voluntary automobile insurance.[31]

4.2.1.2 Trends Among Domestic Insurers

There seems to have been no managerial judgment hazard that has caused bankruptcy in the Japanese voluntary automobile insurance market so far. However, managerial judgment hazard could nevertheless cause losses in this industry.

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[26] According to the latest "Sigma" statistics of 2003 prepared by Swiss Re, while the U.S. had a share of 47.53%, the Japanese market had a share of 9.20% in the world non-life insurance market in 2001.

[27] The Japanese fiscal year starts in April and ends in the following March.

[28] According to the General Insurance Association of Japan, in fiscal 2000, the top five companies occupied a market share of about 57%; however, as a result of the mergers and integration, this share increased to 73% in fiscal 2001 and 84% in fiscal 2002. The Japanese automobile insurance industry has unique characteristics based on *keiretsu* relationships. Keiretsu relationships have been an obstacle for the effective access of foreign insurers to the insurance market in Japan. See Kwon and Skipper (1997) for a detailed explanation about the importance of keiretsu relationships, specifically pp. 154–157.

[29] In addition to the Insurance Business Law of 1939, the Rating Organizations Law (July 1948) governed non-life insurance premium rate, the Retail Activities Law (July 1948) governed retail insurance activities, and the Foreign Firms Law (June 1949) governed the operation of foreign firms in Japan.

[30] See Yamori and Kobayashi (2004) for a detailed explanation about the U.S.–Japanese insurance-related trade talks.

[31] *Nihon Keizai Shinbun*, 2004/4/8. The current recession of Japan, which is its worst ever, and the effect of price competition since July 1998 are regarded as two of the most serious reasons for the industry's poor results.

Table 1. Premium distribution in automobile insurance of the top two Japanese companies

	Net premium (¥billion) (growth rate)						
	F1998	F1999	F2000	F2001	F2002	F2003[c]	F2004
Tokio Marine[a]	6,493 (–2.1%)	6,619 (1.9%)	6,841 (3.4%)	6,956 (1.7%)	6,883 (–1.1%)	6,737 (–2.1%)	8,632 (–2.4%)
Sompo Japan[b]	4,744 (–2.7%)	4,846 (2.2%)	5,009 (3.4%)	5,241 (4.6%)	6,772 (———)	6,736 (–0.5%)	6,712 (–0.8%)
All companies	35,759 (–3.3%)	36,051 (0.8%)	36,653 (1.7%)	36,526 (–0.4%)	36,311 (–0.6%)	35,550 (–1.3%)	35,274 (–1.5%)

F, fiscal year. Source: *Insurance Statistics*, 1999–2004; *Nihon Keizai Shinbun*, 2004/4/8
[a] As for F2003, net premium as Millea Holdings accounts for ¥8718 billion. Tokio Marine's fiscal 2004 figure denotes Tokio Marine and Nichido Fire's figures
[b] Sompo Japan's figures 1998–2001 denote Yasuda Fire and Marine's figures for the same period
[c] As for preliminary figures of fiscal year 2003, net premium of Tokio Marine accounts for ¥6724 billion (–1.8%), Sompo Japan ¥6768 billion (–0.8%), all companies ¥35,730 billion (1.6%)

As a result of the mergers (Table 1), Sompo Japan Co.,[32] the second largest non-life insurance company in Japan, ranked first in the preliminary figures of the premium income of automobile insurance in fiscal 2003. On the other hand, Tokio Marine Co.[33] ranked second in fiscal 2003. It was the first time in its 125 years of history that it lost the lead in automobile premium. Tokio Marine experienced negative growth in fiscal 2002 and 2003. Despite the fact that new products were developed, the premium income fell by 2.1% in fiscal 2003.[34] On the other hand, Sompo Japan experienced 0.8% negative growth in the premium income fall. In fiscal 2004, however, Tokio Marine regained its top position as Tokio Marine and Nichido Fire.[35]

In the process of liberalization, Tokio Marine did not introduce a low price policy until August 2003.[36] Tokio Marine developed a bodily injury indemnity

[32] In April 2002, The Yasuda Fire and Marine Insurance Co. Ltd. merged with The Dai-ichi Property and Casualty Insurance Co. Ltd. In July, after a merger with The Nissan Fire and Marine Insurance Co. Ltd., the company made a fresh start under the name of Sompo Japan Insurance Inc. Subsequently, in December of the same year, the company merged with The Taisei Fire and Marine Insurance Co. Ltd.
[33] In April 2002, Tokio Marine formed a joint holding company—Millea Holdings Inc.—with Nichido Fire, under which these two companies are operating as wholly owned subsidiaries, thus achieving integration of their management.
[34] *Weekly Toyo Keizai*, 2004/4/24, *Nihon Keizai Shinbun*, 2004/4/7, 8.
[35] In October 2004, Tokio Marine merged with Nichido Fire and made a fresh start in the name of Tokio Marine and Nichido Fire Insurance Co. Ltd. Consequently, in fiscal 2004, net premium of Tokio Marine accounts for 8632 billion yen (–2.4%), Sompo Japan 6712 (–0.8%).
[36] Tokio Marine and Nichido Fire and Marine, one of the subsidiaries of Millea Holdings, have sold risk-differentiated automobile insurance since August 2003.

insurance called TAP in October 1998 to provide wider coverage than its existing products. It issued more than 500,000 policies in the first six months.[37]

On the other hand, Yasuda Fire and Marine Insurance Co., the largest former subsidiaries of the present Sompo Japan, have sold risk-differentiated automobile insurance policies since October 1999. Due to their discounts of 10% or less on the existing premiums, more than one million policies had been issued up to March 2000.[38]

The statements of accountants are a good measure to assess directors' decisions. Although it is difficult to identify managerial judgment hazard from these figures alone, there are possibilities of managerial judgment hazards in the case of Tokio Marine. Directors should review their decisions since rate competition began using the requirements of reasonable decision shown in Section 3.2.1. In addition, Sompo Japan should also check whether directors force rapid expansion of its business.

4.2.1.3 Managerial Judgment Hazards of Foreign Insurers

One of the biggest forces for lower rate competition was the sale of voluntary automobile policies based on risk-differentiated rating systems started by several foreign companies through telemarketing in September 1997.[39] They have advertised discounts of 30% or more on the existing premiums for less risky drivers.[40] This method of distribution is now employed by most companies, including domestic ones, and has gradually expanded to other lines.

On the other hand, some foreign companies have withdrawn from the Japanese non-life insurance market.[41] For example, the Allstate Automobile and Fire Insurance Company, a subsidiary of Allstate Insurance Company based in the United States, withdrew from the Japanese automobile business in April 2000. It had sold risk-differentiated voluntary automobile policies in the northeastern rural area of Japan through telemarketing from May 1999. It is said that the main reason for its withdrawal was that the U.S. holding company decided to concentrate on their overseas bases. However, there are also other reasons.[42] About 950 policies against its sales forecasts were issued for 7 months from its entrance. The expense ratio became worse because of the huge administrative cost, specifically

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[37] Hoshino (1999), p. 95. Until the TAP was developed, there was no comprehensive coverage for bodily injury to name insured regardless of issues of negligence.
[38] Insurance (P/C version), No. 3888 (2000/3/23).
[39] This rating system was implemented in September 1997 and many domestic companies are now implementing it.
[40] Hayakawa et al. (2000), p. 400.
[41] Winterthur Swiss Insurance Company, which had actively operated the direct marketing of private auto policies, withdrew from the Japanese automobile business in April 2001. They declared that business in Japan had become unimportant because of a change in its business plan (*Nihon Keizai Shinbun*, 2001/10/17).
[42] *Nihon Keizai Shinbun*, 2001/10/17. The strategies of Japanese companies also had an effect on its withdrawal. This method of distribution had been employed even by several domestic companies at that time.

advertising expenses.[43] Directors had decided to run their business in the northeastern rural area in Japan, because they believed that in general, drivers in this area are good risks compared with those in urban areas, who are bad risks. However, in fact, it was very difficult to earn policies only appealing to lower rates in this area. There are two main reasons that people did not buy Allstate's products: First, people tended to buy insurance through agencies that are run by their relatives and people in the local community. Second, it had no exclusive agent and service office for claims.

The Allstate Insurance Company had decided to enter the Japanese market without fully considering the Japanese rural environment; hence, its decision can be regarded as a managerial judgment hazard. However, withdrawing from the Japanese market very quickly seems to be a reasonable decision. Likewise, Allstate Insurance Company decided to withdraw from Germany and Italy to concentrate its business resources on the northern American market in June 2001.[44] This withdrawal also taught domestic insurers an important lesson regarding whether reconsidering their low rate policies are appropriate.

4.2.2 Lessons Learned from the Japanese Automobile Insurance Market

The Japanese automobile insurance market had remained extremely uncompetitive until 1996.[45] Even though insurance companies have been stringently regulated, there is increasing recognition of the fact that they are required to promote competition and enhance business efficiency under the new Insurance Business Law.

In the current difficult situation, directors' decision making is one of the indispensable roles for insurance companies to be sustainable. It depends on case whether low price policy in the Japanese automobile insurance market leads success.

4.3 Corporate Governance as a Measure to Deal with Managerial Judgment Hazard

As noted earlier, managerial judgment hazards inevitably occur among duties of directors. Until the effects of directors' decisions are revealed, it is impossible to identify whether the managerial judgment hazards have caused losses. What is more, once directors make unintentionally failed decisions, it is very difficult to minimize losses. Therefore, directors should give top priority to adopting a procedure to avoid unintentionally failed decision as much as possible. It is necessary to identify directors' failed decisions as being managerial judgment hazards,

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[43] Matsuura and Sano (2003), p. 98.
[44] *Nikkei Financial Daily*, June 26, 2001.
[45] Few companies had been allowed to enter the Japanese automobile insurance market since 1952.

and the requirement of the business-judgment rule noted in Section 3.2.1 will be helpful in defining a minimum standard of directors' conduct. A sound corporate governance structure as a tool of risk management is effective to deal with managerial judgment hazard. In this section, I will outline three points that are required for sound corporate governance.

4.3.1 Standardization of the Minimum Requirements for Directors' Decisions

Dealing with managerial judgment hazards can be regarded as a part of the compliance-type institutionalization of business ethics.[46] In this institutionalization, directors can standardize a series of procedures to avoid failed decision making. In order to deal with all possible events flexibly, however, the value-sharing typed institutionalization of business ethics is essential for directors to realize what constitutes reasonable decisions.

4.3.2 Organizational Functioning

Furthermore, if control of the board of directors is standardized, directors can make reasonable decisions. The following are procedures of standardization: (i) Directors' accountabilities should be specified. (ii) Directors, including a representative director, should monitor each other. (iii) Some independent, external experts should be appointed to evaluate directors. In addition, information communication systems should be instituted in the corporation, and directors should be able to gather information, including negative information, at all times. Asking consultants to gather and analyze information and paying attention to the movement of other corporations in the same industry are also required. Moreover, once directors make decisions, they should always review them. Further, in case they believe that these decisions could be managerial judgment hazards that would cause losses, they should reconsider the decisions to minimize losses as soon as possible. These procedures form the foundation of corporate governance today.

4.3.3 Support by Stakeholders

In addition, the monitoring duty of the board was made explicit and strongly supported by stakeholders, including stockholders. If this can work at all times,

[46] There are two dominant viewpoints on how business ethics should be institutionalized: one regards ethics as essentially a matter of legal compliance, and the other focuses on the self-governance of each employee according to guiding ethical principles [Paine (1997), pp. 91–93]. Umezu (2002) used Paine's view to identify the path of the institutionalization of "business ethics" and calls the path based on the former the "compliance type" and the latter the "value-sharing type." Indeed, compliance with law is a must and it is easy to standardize each procedure, but the effect of the former is limited because of limitations of the legal standard. On the other hand, it is difficult to standardize each procedure for the latter. However, once the system fulfills its function, it is possible to prevent the occurrence of problems in advance.

managerial judgment hazard would be effectively prevented.[47] In Japan, companies adopting committee-style corporate governance were buoyed by a Commercial Code revision in April 2003, allowing corporations to employ this structure to separate audit functions from operating definitely. This revision implies that a kind of support will be given to each corporation by stakeholders to adopt a sound corporate governance structure.[48] Limiting directors' liabilities is an incentive for assuming this role. For example, upper limits for the liability of directors have been set by a Commercial Code revision since December 2002; as a result, the introduction of such systems for directors and in-house auditors in publicly held corporations has become widespread.[49]

5. Conclusion

Directors' decision making is one of the indispensable roles for corporations to be sustainable; therefore, issues of managerial judgment hazards should not be put off in view of risk management. Besides the moral hazard, it is very important to deal with managerial judgment hazard.

To effectively deal with managerial judgment hazard, directors should give top priority to the identification of directors' failed decisions as a hazard. The conceptual framework and measures to deal with managerial judgment hazard should be distinguished from those of a moral hazard. The business-judgment rule in corporate law grants injunctive relief of director's liability, whereas it is helpful in defining a minimum standard for directors' conduct. In addition, the

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[47] There has been a relatively sudden shift in social norms concerning corporate governance. Until about 20 years ago, the dominant model of the board was that the board was responsible for managing the operational activities of the corporation. The managerial model of the board has now been supplanted by a monitoring model. Further, the basic norms that governed institutional participation in corporate governance were passive norms, reflected in part in the Wall Street Rule: If you don't like the management, sell; if you don't sell, support the management. Today, several institutional investors stand ready to, and periodically do, vote against management proposals and for shareholder proposals. They are willing to sell into tender offers, often pressure management to take specific actions, and sometimes act to achieve changes at the top management level [Eisenberg (1999), pp. 1278–1282])). Eisenberg (1999) concludes that the present social norms of directorial care are obligatory, and that they have an effect either because they are internalized or because of the prospect of reputational sanctions. Shifts in the social norm, in turn, are translated into the fabric of corporate institutions and corporate law [Eisenberg (1999), pp. 1291–1292].

[48] Some institutional investors select issues that will be adopted with a solid corporate governance policy; this is another such example.

[49] The bill was cleared by the Diet in December 2002. Under this act, corporations can introduce the system to limit directors' liabilities. Upper limits of their liabilities are as follows: the liability of the president is less than six times his annual income, and these are four and two times for internal and external directors, respectively. According to a survey by Shouji-Houmu, 284 firms have introduced such systems in December 2003 (*Nihon Keizai Shinbun*, 2003/12/3).

relevant standards of conduct will clarify the directors' best practices, and it will encourage competent individuals to assume directorship.

Although risk financing for managerial judgment hazard is required, a sound corporate governance structure as a tool of risk control is more effective. Directors should adopt a procedure to avoid unintentionally failed decisions by directors as much as possible. Once directors realize that their decisions are managerial judgment hazards, they should deal with these to minimize their losses as soon as possible. Subsequently, stakeholders should routinely monitor managerial performance for sound corporate governance.

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Part III
Corporate Governance in Global Economy

9 The Effect of Global Shareholder Activism on the Japanese Financial System and the Japanese Corporation

Yumiko Miwa

1. Introduction

In the United States and the United Kingdom, large shareholders, such as pension funds, have come to use shareholder voting rights to change the corporations in which they invest. They tend to aggregate their power and participate in corporate governance actively. Management must now listen to their voices because there is a possibility that institutional investors will reject the management's slate of board nominees. More recently, management has been likely to agree to meet informally with institutional investors.

Institutional activism seems to be an attempt to accomplish an effective relationship between the corporation, shareholders, and other stakeholders without sacrificing the historical advantage of the market's liquidity and efficiency. Institutional investors in the United States have increased international investment since the 1990s. They have become more active in the corporate governance of foreign corporations. These kinds of movement have had a significant effect on the Japanese financial system and corporate governance.

2. Significance of Exercising Shareholder Voting Rights by Institutional Investors

The movement to promote in a positive manner the exercising of voting rights by institutional investors has flourished recently in Japan. This movement has been strongly influenced by British and American institutional investors and relevant authorities.

In 1988 the U.S. Department of Labor expressed its view in the so-called Avon Letter that "exercising voting rights is also recognized as one part of a fiduciary's responsibility," and officially published its opinion that institutional investors and even fund managers must bear the obligation of exercising voting rights. This is an official view released on the occasion of the U.S. public employ-

ees' pension starting to exercise its rights to submit shareholder proposals in 1987.[1]

In England, the FMA (Institutional Fund Managers' Association) advised its whole range of member fund managers, "You should enter into serious considerations to systematically exercise voting rights for your trust guarantors." In the same year, the ABI (Association of British Insurers) stated in its discussion paper, "Institutional investors should support the board of directors by exercising voting rights in a positive manner.[2]"

In 1991, the PIRC expressed its opinion to the Cadbury committee, "Voting rights are an asset, and must be administered with careful obligation (care and independence required of the person in the position of fiduciary). Shareholder voting rights must be exercised methodically and exceptionally for the long-term benefit of the beneficiary." In the following year, the Cadbury committee responded to the views of the ISC and the PIRC, "We must recognize voting rights as an asset. Exercising voting rights by institutional investors, or the non-exercise thereof, is an issue of proper benefit which inures to the person for whom we invest. We believe institutional investors should disclose their policies regarding their use of those voting rights."[3]

In November 2002 the SEC carried out a proposal requiring mutual funds to disclose in their Statements of Additional Information (SAIs) their policies and processes leading to exercising voting rights of stocks that they hold. The SEC related the following as background to this.

> As of November 2001, mutual funds hold $3.4 trillion in stock. This is 19% of total U.S. stock issue. Compared with the 6.4% ten years before, the rate of expansion is high. Millions of American investors hold shares of mutual funds, and they rely on these funds, i.e. the stock of the companies in which they have invested, and hold these funds to meet their financial needs for retirement, children's education, etc. Despite the huge influence of mutual funds on capital markets and their huge influence on financial assets of American investors, the funds have not made clear how they exercise voting rights of the securities they hold. We believe that now is the time to consider increasing transparency on the state of voting rights in mutual funds. Raising transparency in this way, fund shareholders will be able to check how the fund is participating in governance activities of the securities they hold. This will have a dramatic influence on shareholder value.[4]

In this way, in Great Britain and the United States, exercising voting rights by institutional investors is viewed as one part of the responsibility of the fiduciary and as an obligation in the capital markets.

In Japan also, there are indications that the role of institutional investors in corporate governance is viewed seriously.

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[1] Avon Letter (1998).
[2] ISC (1991).
[3] NAPF (1995).
[4] SEC (2002).

Corporate managers are indeed subject to the control of capital markets, but it can be said that it is necessary to manage the business with a deep respect for the long-term returns of the company through nurturing shareholders. . . . As can be seen from recent developments in the U.S.A., shouldn't institutional investors of pension funds and investment trusts themselves proceed with corporate governance as mid- and long-term shareholders?[5]

Before anything else, the obligation of the shareholder in the stock-held corporation system is to supply capital. But as stated above, institutional investors as fiduciaries bear the obligation of exercising voting rights. The fact that exercising voting rights is part of asset investment by institutional investors means that they bear the "responsibility to themselves create important factors for the stock price to rise (important factors for it not to fall)."

The mission of investors who make a business in investing assets is to provide investment returns by gauging the future based on current information, and to invest in companies whose stock price, it seems, will go up. As the "separation between ownership and management" expands, corporate managers have been placed in the position of administrators of society, and they have come to bear the duty of making sure their companies continue to exist, that is, responsibility for their companies' profitability and their products. However, there are instances when managers of modern big businesses use their position as administrator and take actions to pursue their own benefit, not that of the corporation. Or in the position of administrator, there are also corporate managers who have no ability to accomplish their responsibilities. Staving off actions of these kinds of managers is a new role sought in institutional investors. That is to say, in modern large corporations, institutional investors bear a part of the responsibility in ensuring the continuing existence of the company, its profitability, and its goods and services.

3. Japan's Financial System Reform and Pension Fund Asset Management

Financial system reforms that were promoted after November 1996 aimed at reinvigorating Japan's financial markets to align them with the international financial markets of New York and London by 2001, and the reforms were based on the three principles of "free" (free market where market mechanisms work), "fair" (market that is transparent and reliable), and "global" (market that is international and ahead of its time). Incorporated in these financial system reforms were stock trading system reforms such as liberalizing commissions on stock transactions and liberalizing the system of trades outside the market, and encouraging participation by the banking, brokerage, and insurance industries. That is, a goal was set to devise efficient management of the Japanese people's assets

[5] Morita (2002).

under conditions in which a great variety of brokers utilizing cheap and efficient stock trading systems would compete with one another on a global scale for a wide variety of high-quality asset investment and management services. Thus, in order to invest ¥1.4 quadrillion in individuals' assets under risk management, positive utilization of investment trusts (funds) was promoted, and participation in the stock market by institutional investors of pension and other funds was promoted as well.

Growth in investment trusts and pension funds signifies an increase in indirect stock ownership through financial brokerage institutions rather than direct stock ownership by households. After the Second World War, financial brokerage institutions continued to grow in Britain and the United States and to become powerful stock investment entities, i.e., institutional investors. Their influence gradually increased, and it became significant to study the reasons for the growth of these institutional investors, their role, investment activities and strategies, and their characteristics. The enormous capital of pension funds in Japan also exposed the need for increasing the rate of investment in stocks, and the activities of institutional investors began to draw attention.

3.1 Relaxing Investment Regulations and Managing Pension Assets

3.1.1 Managing Assets of Public Pensions

In the pension system reform draft of 1999, it was discussed how best to take a new look at public pension payments and burdens in light of the lower birth rate and aging of society. The new Government Pension Investment Fund was established to independently invest public pension reserves as of April 2001.

The target investment return for the new pension assets was set at 4.5%, and in order to assure this target return, the decision was made to invest 68% of the total assets in domestic bonds, 12% in domestic stocks, 7% in foreign bonds, 8% in foreign stocks, and 5% in short-term assets. A certain leeway was built into the asset distribution structure. Domestic stocks, for example, could be increased or decreased by 6 points from the 12% mark. Reserves are estimated to be ¥150 trillion around year 2010, and of that, if 12% is attributed to stocks, the stock portfolio will be worth ¥18 trillion. Of the approximately ¥82 trillion managed assets in fiscal year (FY) 2002, ¥12.4 trillion was the amount of managed assets invested in stocks. It is rare throughout the world for public pension funds that have adopted a taxation method to invest in stocks, but Japan's public pensions already have capital of more than ¥12 trillion invested in stock, and alone they are the largest holder of stocks. With the Government Pension Investment Fund, concerning about management of the nation's private industry, the need to rely on fiduciary institutions having shareholder voting rights has been exposed.[6]

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[6] See http://www.gpif.go.jp/unyou/unyou16/gaiyou16.pdf, pp. 3–5.

3.1.2 Relaxing Investment Regulations of Corporate Pensions

At the end of 2003, corporate pensions held assets of ¥71.2684 trillion yen. Of this, ¥51.2805 trillion, or 72% were assets of the Pension Fund Association. If one looks at this distribution by fiduciary institution share of corporate pensions, at the Pension Fund Association, 28.9% were life insurance companies, 50.3% were trust banks, and 20.8% were investment consulting firms. For tax-qualified pension plans, 51.8% were life insurance companies, 42% were trust banks, 5.3% were investment consulting firms which became able to be fiduciaries after October 1997, and 1% was the National Mutual Insurance Federation of Agricultural Cooperatives (Zenkyoren). In recent years, there has been a tendency for the share in investment consulting firms to grow for both the Pension Fund Association and tax-qualified pension plans.

Asset management in the fund was restricted by the so-called 5-3-3-2 Regulation of the uniform Legal List Rules. Before the revision in Pension Fund Association regulations in 1997, investment was carried out for all funds uniformly under an assumed rate of return of 5.5%. But since the 1990s, they were not able to achieve the assumed rate of return, and the inefficiency of investing under legacy asset distribution regulations and the dissipation of fiduciary responsibility became a problem. So the 5-3-3-2 regulations went through a gradual revision and in 1997 they were completely eliminated. Investment consulting firms were allowed in 1990 to participate as fiduciary institutions only as a part of expanded investment. In 1999 the distinction between expanded investment and legacy investment was eliminated. This is how relaxing regulations on investing was advanced, and currently the system has widened even more to encompass competition from investing institutions, including those of foreign capital lineage who act as fiduciaries for pension fund assets.[7]

While relaxing regulations on pension fund asset investments was progressing, relaxing regulations on the markets for asset investment was also in progress. In the "financial system reforms" (called Financial Big Bang in Japanese) proclaimed in 1996, reforms such as liberalization of stock transaction commissions, abolition of obligation to centralize transactions at the stock exchange, and introduction of privately subscribed investment trusts and corporate-style investment trusts came into effect, all of which had a great influence on institutional investors' management of assets. With the relaxing of pension fund investment regulations, a gigantic amount of capital flowed into the securities markets, and legacy regulations in the securities markets were abolished so institutional investors could more easily utilize these markets. From this point on, it was expected that investment fiduciary institutions like trust banks, life insurance companies, investment consulting firms and others would become positively involved in investing risk assets like stocks.

Until this time, investment had just been left up to groups like life insurance companies and trust banks, but now each investment institution, including

[7] Life design kenkyusho (1999), p. 33.

investment consulting firms, would have to carry out investments in accordance with the Prudent-Man-Rule.

3.1.3 Increases in Passive Investment

Investment efficiency is required of Japanese pension fund investment trustees and fiduciaries, and asset distribution is an important problem. A characteristic of recent years is that the ratio of investment in stocks is rising, and as a part of that the move to increase the rate of passive investment that dovetails an index (stock index) continues to expand. If one examines the rate of passive stock investment of U.S. and Japanese large pension funds, the U.S. rate stands at 76% while Japan does not exceed 15%. Active investment that carries out investment in individual corporate issues incurs research costs, and the more there is diversity in investment institutions, the higher the commissions that are paid. In spite of this the investment performance may from time to time be below that of a stock index. However, in passive investment research costs are unnecessary, and in general investment commissions seem to be about one third those of active investments. In recent years, pension funds are clearly cognizant of investment costs and are increasing their rate of passive investments.[8]

3.1.4 Competition Among Active Investment Fiduciary Institutions

There seems to be a move among large investment banks and others to create passive investment teams as fiduciaries for pension assets; and for active investments, investment consulting firms, for whom the investment trustee ban was lifted in April 1990, have increased competition to acquire fiduciary relationships. The fiduciary balance for domestic pension funds at the end of FY2003 was ¥32.4364 trillion yen, an increase of 27.4% over the previous fiscal year. A breakdown of this fiduciary capital shows public pensions at ¥14.886 trillion yen, an increase of 15.3%, and corporate pensions at ¥17.5504 trillion yen, an increase of 39.8%. Corporate pension funds that had been eyeing an improved rate of return showed a tendency to utilize investment consulting firms. In recent years the fiduciary roles of foreign capital lineage investment consulting firms in pension assets have been increasing. The vigor of JP Morgan, Merrill Lynch Mercury Asset Management, Fidelity, and other American investment companies has been striking. Japanese life insurance companies and trust banks have joined forces with foreign capital lineage investment firms with a strategy to expand their asset investment business. Take, for example, the ties between Dresdner Kleinwort Benson and Meiji Life, Putnam and Nihon Life, Allianz and Sumitomo Trust Bank, etc.[9]

In this way, domestic and foreign investment consulting firms, as well as trust banks and life insurance companies that had been entrusted with legacy investing, are competing in investment performance to gain pension asset fiduciary

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[8] See *Nikkei kinyu shinbun*, "pension money increases passive investment," Nov. 30, 2000.
[9] McDonald (1998).

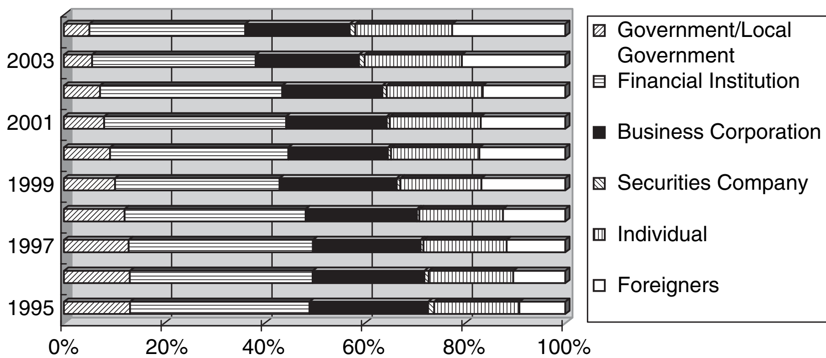
trusts. Moreover, the competition for fiduciary trust in pension assets by foreign capital lineage investment consultants is expanding into alternative investments like hedge funds and unlisted stock investment (investments in assets outside traditional stocks and bonds).

4. Changes of Stock Ownership in Japan

A characteristic of the Japanese stock market used to be mutual stock ownership. However in the 1990s, stock prices dropped quickly and stagnation continued for quite a while afterwards. This expansive drop in stock prices and stagnation eliminated unrealized gains in stock held by financial institutions and companies and forced them to account for unrealized losses on their books. Because of this, financial institutions and companies that mutually held each other's stock were forced to dig in their heels during the stagnation in corporate earnings, and corporate earning strength deteriorated even more because of the unrealized losses. As a result, the structure of mutual stock ownership in Japan collapsed and stock ownership by institutional investors such as pension funds and foreigners expanded.

Table 1 shows the shift in investment sector-specific equity stakes over the most recent 10 years. A characteristic of this period is a continuing flow in which financial institutions sell stock and foreign investors buy stock. Equity stakes by foreign investors stood at 23.7%, the highest since such studies began in 1970. Equity stakes of corporations stood at 21.9% because they acquired high levels of their own company's stock despite selling due to the liquidation of mutual holdings in those years. Long-term credit banks, municipal banks, and regional banks reduced their equity stakes for 10 years in a row, and life insurance companies and non-life insurance companies reduced their equity stakes for 4 years in a row, reaching new lows for each of the three sectors since such studies began.

TABLE 1. Shift in Equity Investment by Sector (10 years)



National Securities Exchange "Distribution of Stock holdings 2004" p. 5

Throughout these 10 years, pension trusts were actively engaged in stock investment and increased their equity stakes, but from FY2003 they tended to sell stock along with the Pension Fund Association's Agency Return (returning their obligation back to the government to act as its agent in making partial pension payments), and their equity stakes stood at 4.0%.

In FY2004 foreigners invested a huge amount of capital in the Japanese stock market with purchases exceeded ¥6.3563 trillion yen. Looking at industry sectors in which foreigners bought stock, they bought a wide spectrum of all industry sectors, and there was a tendency to greatly increase equity stakes in industries where industry-specific stock price indicators were increasing at a greater rate, particularly food, electricity and gas, and machinery.[10]

What countries had investors holding Japanese stocks? According to documents of the Bank of Japan, as of the end of December 2003 foreign investors held a total of ¥60.1 trillion in Japanese stocks, and a breakdown of this by country shows that ¥25.1 trillion or 41.8% of the total was investment of American capital, and ¥18.6 trillion or 30.9% was British capital.

If one looks at percentage of stock ownership, British and American investors stand out at the head of the list with more than 70%, and the tendency is the same for the number of investors. Currently, among institutional investors (excluding hedge funds) that actively manage their Japanese stocks and hold more than ¥10 billion in Japanese stock assets, there are about 100 companies in the United States and 80 companies in Britain. In comparison, there are about 50 such companies on the European continent. The British and American institutional investors are more active in exercising shareholder voting rights than investors from other areas, and because of this, the British and American institutional investors are very influential in Japanese companies.

As of the end of FY2004, there were 104 companies in which foreigners had equity stakes of 30% or more, 29 more companies than 1 year before. Canon was among those newly added to the companies in which foreigners' equity stakes exceeded 50%, doubling the number to six companies. Table 2 shows major companies that have high foreign equity stakes, and companies that have large market share and continue to demonstrate high rates of profit are adding their names to the top of this list. The company that has the highest foreign equity stake, 57.2%, is Orix Corporation. Through the last quarter, Orix's net profit hit new highs for two straight quarters, and the management team annually makes several investor relations trips to Europe and the United States to strengthen their development of overseas investors. Hoya, Canon, Nitto Denko, Fuji Photo Film, etc., have a lot of products which rank #1 or #2 in the global market share, the overseas percentage of their sales which adds to their stabilized earnings power is high, and they are very popular among foreign investors. Powerful companies involved in domestic demand such as those in the service or retail industries are also adding their names to this list. Yamada Denki, leveraging its

[10] See http://www.tse.or.jp/data/examination/distribute/h16/distribute_h16a.pdf, pp. 1–6.

TABLE 2. Major Japanese companies that have high foreign equity stakes (2004)

	%	Rate of change (1 year)
1. Orix	57.2	6.5
2. Hoya	55.6	5.1
3. Yamada Denki	55.6	5.5
4. Credi Saison	52	9.8
5. Canon	51.7	1.8
6. Don Quijote	50.9	9.9
7. Nitto Denko	49.5	4
8. Matec	49.5	9.7
9. Fuji Photo Film	48.7	4.5
10. Rome	48.7	1.7

Source: *Nihon Keizai Shinbun*, June 28, 2005

aggressiveness in adding outlets, became the first specialty store to break through ¥1 trillion in sales in the March 2005 period. Don Quijote, Meitec, Aderans, etc., command a high share in their niche markets, and are highly rated as companies showing steady gains.

With the increase in foreign investors, even in companies with high earnings power, management supervision in areas of use of capital, the way corporate governance should be, information disclosure and accountability tend to be strengthened. Tokyo Electron has a foreign equity stake of 41.5%, and in the FY2004 shareholder meeting expansion of the limits on stock issuance was voted down. It seems that one reason for this was that some of the foreign stockholders opposed it.[11]

5. Recent Pension Fund Activism and the Response of the Corporations

5.1 Japanese CalPERS, Pension Fund Association

The Pension Fund Association is called Japanese CalPERS, because it is influenced by the CalPERS to exercise voting rights actively. I will summarize here the June 2005 shareholder meeting results of PFA's in-house exercise of shareholder voting rights.

When it came to exercising shareholder voting rights in the June 2005 shareholder meetings, voting rights were exercised for all proposals (a total of 5773 proposals over 1347 companies) on the agendas after examining each item based on the Pension Fund Association Criteria for Exercising Shareholder Voting Rights.[12]

[11] *Nihon keizai shinbun*, "Foreigners shareholding is increasing," June 28, 2005.
[12] See http://www.pfa.or.jp/jigyou/pdf/gov_inhouse17_6.pdf.

When it came to examining proposals, shifts in corporate performance and governance structure were essential elements, and the proposals were judged comprehensively from a viewpoint of how management efforts would be put into practice to maximize shareholder profit; and for proposed items difficult to judge based on these criteria, after a detailed examination of the contents of the proposal and individual examination, discussions were undertaken by the voting rights exercise committee as necessary. Cases of significant items towards which the Pension Fund Association expressed its opposition in the June 2005 shareholder meetings follow.

- Proposals for Disposition of Profits
  In the past 5 quarters, aggregate profit or loss (consolidated) was in deficit; corporate performance was in long-term stagnation
- Proposals to Change a Portion of Articles of Incorporation
  - Without any explanation of a concrete reason, expanding the authorized limits on stock issuance, or attempting to make Stock Issuance Date more flexible
- Proposals to Elect Directors
  - Despite long-term corporate performance slump or significant effect on corporate performance due to eruption of a scandal, renominating a Director for election who should be questioned about his management responsibilities
  - Not electing even one outside Director
  - Decreasing number of outside Directors
  - In companies with committees established, when an executive originating from a company that is already a major shareholder (holds more than 1/3 of total voting right shares) becomes a candidate for outside Director
- Proposals to Grant Special Retirement Service Bonuses
  - Paying special retirement service bonuses despite questions that should be asked about management responsibilities during a continuing slump in long-term corporate performance
  - Paying special retirement service bonuses to outside Directors or Corporate Auditors who are required to maintain a high degree of independence
- Proposals to elect Corporate Auditors
  - Without any explanation of a concrete reason, decreasing number of Corporate Auditors
- Proposals to Grant Stock Options
  - Granting stock options to people who do not seem to have any strong connection to raising corporate performance

Shareholder motions were considered individually, and proposals such as individual disclosure of Directors' compensation, establishment of Directors' personal stock acquisition parameters, or increasing dividends were voted yes in cases where it was recognized that they would accrue to shareholder profits.

Response to Corporate Buy-out Defense Policies

- Yes votes in cases (4 companies) in which a Rights Plan in accordance with standards of the Association was introduced
- Yes votes to expand limits on authorized stock issuance in cases in which there were concrete explanations and the purpose of which was clearly not a defense against a corporate buy-out
- Opposition, as a rule, to relaxing Stock Issuance Dates if the possibility to impair stockholder value was incontrovertible
- However, yes votes on reducing the fixed number of Directors if there was some leeway to implement it as a defense against a buy-out and it was a fundamentally beneficial move

The Pension Fund Association established the Corporate Governance Fund in March 2004 as a part of its corporate governance activities. This fund, based on questionnaires and visits to the companies, sorts out and invests in corporate issues recognized as excelling in governance as reflected in concrete corporate governance evaluation criteria, and joined ranks with 43 companies in August 2004. In June 2005 it conducted new studies and added 10 more corporate issues to these ranks.[13]

(1) Governance Evaluation Criteria

Based on "Governance Evaluation Criteria" worked out among the Pension Fund Association, its investment trustee Nomura Asset Management, and Nomura Research Institute, they evaluated companies' governance, and companies which were judged as having a high level of governance were selected. In evaluating companies' governance, it was not enough that companies had formalized systems such as a transition towards a company with committee structures or adoption of outside directors, but placed great importance on how those mechanisms function effectively to produce material results.

(2) Research by Questionnaires

They implemented a questionnaire targeting companies listed on the 1st Section on the Tokyo Stock Exchange and gathered basic information regarding governance of these listed companies.

Second Questionnaire Results

Companies Sent Questionnaires: 1548 companies

Companies Responding to Questionnaires: 847 companies (55% answer rate)

Companies Responding to Questionnaires Aggregate Value: 85% of total value of 1st Section listed companies

(3) Research by Visits to Companies

Investment trustee Nomura Asset Management analysts and portfolio managers visited companies, scrutinized actual governance conditions, and carried out final evaluations.

[13] See http://www.pfa.or.jp/jigyou/pdf/gov050607.pdf.

Governance Evaluation Criteria

1) "Stressing Stockholder Value" is a distinct management principle and objective
   - The principle of "Stressing Stockholder Value" is distinct
   - The stockholder is afforded the position of an important stakeholder
2) Establish and disclose business numerical targets which recognize shareholder equity cost
   - Conducting business which recognizes shareholder equity cost
   - Together with setting concrete business numerical targets, evaluating and disclosing the degree to which those targets are achieved
3) Drawing up and executing a proper business strategy
   - Establishing and disclosing business numerical targets which recognize shareholder equity cost in specific business sectors
   - Setting criteria for exiting a business

1. Business Stressing Shareholder Value
   1) An attitude of giving back to the shareholder
      - Dividend pay out ratio and shareholder equity ratio at appropriate levels
      - Carrying out appropriate corporate stock buy backs
   2) Having a responsible system for Investor Relations
      - Full-time Investor Relations position with sufficient staff in place
      - Company President himself attending Investor Relations meetings and being accountable
   3) Substantial information disclosure
      - Disclosing sufficient information on the company's website homepage
      - Award-winning Investor Relations activities
   4) Timely disclosure system
      - Disclosing appropriately other information in quarterly disclosures, not just limiting the information to sales figures, etc.
      - When significant facts arise, disclose them quickly on the company's website homepage
2. Information Disclosure & Accountability
   1) Access to shareholder meetings
      - Notification of Meeting is sent with enough lead time
      - Constructive posture towards computerizing the exercise of shareholder voting rights through an intention to participate in the "Platform for Exercising Shareholder Voting Rights" recommended by the Tokyo Stock Exchange.
      - Allow public access to Notification of Meeting and related documents on the company's website homepage
   2) Distinguishing between Business Execution and Supervision
      - The same person does not have co-responsibilities of Chairman of the Board and CEO

- More than 1/3 of the Board of Directors are not Directors who also have the duties of an executive
- The number of Directors is 20 or less

3) Independence of outside Directors
- Number of outside Directors is more than 1/3 of the Board of Directors
- Independence of outside Directors is guaranteed

4) Effectiveness of outside Directors is guaranteed
- Attendance ratio at Board of Directors meeting by outside Directors is above a certain level
- Together with advance distribution of materials to outside Directors, appropriate explanation is also made

5) Method of nominating Directors (for a company that has established committees)
- Nominating criteria for Directors are in statutory form
- Chairman of Nominating Committee is an outside Director
  (for a company that has adopted Corporate Auditor system)
- Nominating criteria for Directors are in statutory form
- Systematic correspondence is made by the Nominating Committee, etc.
- There are members of the Nominating Committee from outside the company

3. Board of Directors

1) CEO (top executor) Leadership
- Former chairmen & former company presidents are not in a position of strong influence like the Board of Directors

2) Disclosure of the executive compensation decision process and compensation amounts (for a company that has established committees)
- Chairman of Compensation Committee is an outside Director
  (for a company that has adopted Corporate Auditor system)
- When setting compensation, there is independent organization for the compensation committees
- There are people from outside the company included in compensation committees

3) Presence of an Achievement-Based Compensation System and its Details
- Introduction of an achievement-based compensation system for executive compensation
- Introduction of a stock option system, and the conditions for granting options are appropriate

4. Executive Compensation System
- Acquisition and Holding of Company Stock
- Rules for acquiring stock in an executive's own company, and criteria for acquiring such company stock are expressed in numerical values

1) Operations of the Corporate Audit Committee & Board of Corporate Auditors (for a company that has established committees)
- Staff belonging exclusively to the Corporate Audit Committee is secure in both quality and quantity

- Meetings are held regularly among Corporate Audit Committee members and independent auditors and the internal audit office, etc. (for a company that has adopted Corporate Auditor system)
- Staff belonging exclusively to the Board of Corporate Auditors is secure in both quality and quantity
- Meetings are held regularly among the Corporate Auditors and independent auditors and the internal audit office, etc.

2) Compliance System
- There are an exclusive post and internal company regulations regarding compliance, and employee training regarding compliance is conducted
- An internal reporting system is set up with an exclusive post and an outside third party as a central resource

3) Responding to Unforeseen Circumstances
- A manual is prepared for responding to accidents, scandals, etc.
- After accidents, scandals, etc. occur, appropriate explanations are made

5. Compliance and Risk Management

1) A Healthy Relationship with Independent Auditors
- There are clear rules when requesting non-audit business of independent auditors
- There is currently no contract for non-audit business with independent auditors

5.2 Trends in Shareholder Meetings in June 2005

Shareholder meetings were held at the end of June for about 1600 companies whose fiscal year closed in March 2005. In this hostile fiscal year, in preparation for hostile takeovers that began to be conspicuous even in Japan, there was an onslaught of motions introduced by companies as plans of resistance. However, motions by Fanuc, Tokyo Electron, and Yokogawa Electric requesting an expansion of limits on stock issuance of these three companies were voted down by opposition of domestic and foreign institutional investors. Common among these three companies were: a high percentage of foreign stockholders; abundant capital at hand; there seemed to be no obstacle for current capital investment plans; and they would more than double issuance of authorized capital. In other words, if they were to increase the issuance at the shareholder meeting, the number of shares that could be issued would increase at the judgment of the board of directors. Because of this, the issuance of stock for unaccounted purposes could dilute shareholder value. If this situation were just left alone, it would result in concerns that institutional investors could be questioned about their fiduciary responsibilities.

There were many companies where opposition votes were cast for proposals to appoint new directors. Since the authority of directors was expanded through a revision in corporate law in June 2005, a vote of confidence in management took on added strength in shareholder meetings. Also, pressure from shareholders was intense regarding systems of executive compensation. Sony and

Toyota Motor Corp. received shareholder motions for itemized disclosure of executive compensation from NPOs. "Yes" votes at Sony totaled 39% and at Toyota totaled 25%, showing an extremely high number. Sojitz Holdings submitted a motion to raise the scope of total compensation along with an increase in the number of directors and corporate auditors due to the merger with its subsidiary. This motion was approved with a majority "yes" vote, but in the annual meeting expressions of opposition were continually raised toward increasing compensation totals regardless of the rebuilding in progress. There were also shareholders who showed up expressing their opposition to the merger proposal. According to a study by the Nihon Keizai Shimbun, as many as 80% of the institutional investors of the top 100 companies ranked by invested assets responded that they "had opposed proposals" in the June 2005 shareholder meetings. This shows that institutional investors continue to have a hand in corporate governance by exercising shareholder voting rights.[14]

6. Conclusion

In this chapter, I focused on the changes of the Japanese financial system and the institutional investor's activism, which are heavily influenced by the institutional investor in the United States.

Japanese financial system reform, which is based on the three principles of "free," "fair," and "global," was identified in the globalization of the U.S. investor's actions.

The U.S. institutional investors' influence gradually increased, and it became significant to study the reasons for the growth of these institutional investors, their role, investment activities and strategies, and their characteristics.

Today, the structure of Japanese stock ownership is changed dramatically. It used to be said that a characteristic of the Japanese stock market was mutual stock holding. However, the expansive drop in stock prices and stagnation eliminated unrealized gains in the stock held by banks and companies. Because of this, banks and companies are forced to sell their stocks. Now, foreign investors are taking banks and companies' places. They have a significant impact on Japanese corporate governance.

One of the biggest institutional investors, the Pension Fund Association, have learned CalPERS investment behavior and they have begun to use their voice to change the corporations in which they invest. This shows institutional investors continue to have a hand in corporate governance by exercising shareholder voting rights and thus, Japanese companies tend to lend their ear to institutional investors.

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[14] *Nihon keizai shinbun*, "Shareholder Meetings in June 2005", June 30, 2005.

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10
OECD Principles of Corporate Governance

Nobuyuki Demise

1. Introduction

Many people, including institutional investors, company executives, lawyers, scholars, and administrators, are interested in corporate governance around the world. These trends are related to corporate scandals, the developing markets, and the global activities of both company and investor. There are efforts to develop a universal corporate governance code that can apply worldwide. OECD (the Organization for Economic Cooperation and Development), which published the *OECD Principles of Corporate Governance*, provides a definition:

Corporate governance is the system by which business corporation are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as the boards, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and means of attaining those objectives and monitoring performance.

This chapter describes the OECD corporate governance principles and their influence on Japan.

2. Original Version

In the late 1990s, a series of financial crises occurred in Asia, due chiefly to lack of transparency and accountability. At that time the OECD established an advisory group to draw up corporate governance principles. I.M. Millstein, A. Cadbury, and N. Tateishi were the members of the advisory group. They each had become famous for reforming corporate governance in their country. They reported to the OECD as follows.[1]

[1] OECD (1998), p. 13.

> To succeed in their primary objective of generating long-term economic profit, corporations must seek to achieve a sustained competitive advantage. This requires significant flexibility to take necessary risks in responding quickly to opportunities and challenges in constantly changing environment. Corporations must be able to develop and implement their respective competitive advantages, to raise capital, to assemble and redeploy resources to that end and, at same time, to meet the expectations of their shareholders, employees, suppliers, creditors, customers, communities and society at large.

They suggested that the purpose of the corporation was to generate long-term economic profit and they regarded stakeholders as important. In the preface of *OECD Principles of Corporate Governance*, it is pointed out that corporations are important for the welfare of individuals. Corporations create jobs, generate tax income, produce a wide array of goods and services at reasonable prices, and manage savings and secure the retirement income. On the one hand, the drafters of the principle think that corporations are important for the private sector. On the other hand, they think governments play an important role in shaping the legal, institutional, and regulatory climate within which individual corporate governance systems are developed.

The notion of "corporate governance" in *OECD Principles of Corporate Governance* is not a view from only short-term shareholder value. It regards long-term success of the corporation as important, and as a result long-term shareholder value is realized. The drafters of the principle point out:[2]

> The best-run corporations recognize that business ethics and corporate awareness of the environmental and societal interest of the communities in which they operate can have an impact on the reputation and long-term performance of corporations.

This does not mean that shareholders are not important. In the preface, common to all good corporate governance regimes is a high degree of priority placed on the interests of the shareholder. In the principles, the corporate governance framework should protect shareholders' rights and should ensure the equitable treatment of all shareholders. The *OECD Principles of Corporate Governance* was published in 1999. The contents are as follows.

- The rights of shareholders
- The equitable treatment of shareholders
- The role of stakeholders in corporate governance
- Disclosure and transparency
- The responsibilities of the board

The rights of shareholders include the right to participate and vote in general shareholder meetings, the right to elect members of the board, and the right to share in the profit of the company.[3]

In the section of the responsibilities of the board, the corporate governance frameworks should ensure the strategic guidance of the company, the effective

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[2] OECD (1999), p. 6.
[3] OECD (1999), pp. 15–16.

monitoring of management by the board, and the board's accountability to the company and the shareholders.[4] The responsibilities of the board are to act in the best interest of the company and the shareholders, and to take into account the interest of stakeholders.

As the preamble to the *OECD Principles* states, there is no single model of good corporate governance.[5] There are different legal systems, institutional frameworks, and traditions around the world. The Business Sector Advisory Group on Corporate Governance clarified four values, fairness, transparency, accountability, and responsibility, to improve corporate governance. The many institutional investors think that these values are important. The ICGN (International Corporate Governance Network) applauded the *OECD Principles* as a declaration of minimum acceptable standards for companies and investors around the world.[6] The ICGN is an investor-led body representing more than US$10 trillion in assets. The large institutional investors are in favor of reforming corporate governance around the world. The next section describes the influence of the principles on Japanese business society.

3. Influence on Japan

The *OECD Principles* influenced the direction of the reform of corporate governance around the world. OECD and the World Bank Group affect nonmember nations, especially developing nations. The World Bank Group published *Corporate Governance: A Framework for Implementation* in 2000. The overview of *Corporate Governance* states that *OECD Principles* deals mainly with internal mechanisms for directing the relationship of managers, directors, shareholders, and other stakeholders.[7] The World Bank Group provide a framework for corporate governance that reflects an interplay between internal incentives and external forces that together govern behavior and performance of the firm. In the annex of *Corporate Governance*, the authors emphasized that most Japanese companies were affiliated with *keiretsu*, and they asked whether keiretsu was a good corporate governance system or whether it placed companies in double jeopardy.[8] They used the term "double jeopardy" because keiretsu was characterized by a main banking system and crossholding of shares. The main bank encouraged excessive leveraging and investment in highly risky areas and crossholdings prevented hostile takeovers.

The reform of the corporate governance regime is related to the legal, economic, and social institutions and also to the culture of the nation. After the publication of the *OECD Principles*, the Japanese Commercial Code was revised in

[4] OECD (1999), pp. 20–21.
[5] OECD (1999), p. 9.
[6] Monks and Minow (2004), p. 300.
[7] Iskander and Chamlou (2000), p. 7.
[8] Iskander and Chamlou (2000), p. 93.

2001. Large Japanese companies were required to extend the term of office for corporate auditors by this amendment. The liability of compensation was set an upper limit, which was fixed by the remuneration of directors. These measures were not related to the *OECD Principles*. The Japanese Commercial Code revised in 2003 enables Japanese companies to introduce a board committee system and abolish the auditor system. The board committee system is composed of the audit committee, the nominating committee, and the remuneration committee, and the majority of members in each committee are directors from outside the company. These are slightly related to the *OECD Principles*, because the role and structure of the board was made clear by this amendment. However, the amendment did not include the disclosure on the remuneration of each director.

The Japan Corporate Governance Forum (JCGF), which was made up of executives, academics, lawyers, and shareholder representatives, issued *Corporate Governance Principles* in 1998. The members of the forum understood the need for improved corporate governance in Japan. The principles were composed of four parts: Accountability and disclosure, Directors and the board of directors, Auditor and the board of auditors, and General meeting of the shareholders.[9] After JCGF presented these principles, some companies began to reform their corporate governance regimes and CalPERS (the California Public Employees Retirement System) put the JCGF *Corporate Governance Principles* at the heart of its Japanese voting guidelines.[10] After that, JCGF set up the Japan Corporate Governance Committee to revise these principles. They appreciated the changes both domestically and internationally and prepared these revised principles accordingly. JCGF published the *Revised Corporate Governance Principles* in 2001.[11] The contents are as follows.

- Position and purpose of the board of directors
- Function and powers of the board of directors
- Organization of the board of directors
- Outside directors and their independence
- The role of the leader of the board of directors
- Establishment and composition of committees
- Role of each committee
- The role of the CEO
- Executive management committee
- Litigation committee
- Internal control
- Disclosure
- General meeting of shareholders
- Investor relations

[9] See http://www.jcgf.org/jp/.
[10] Monks and Minow (2004), p. 318.
[11] See http://www.jcgf.org/jp/.

One of the members of the committee was N. Tateishi, who also was a member of the advisory group to draw up *Corporate Governance Principles*. These revised principles were related to the *OECD Corporate Governance Principles* because the position, function, and structure of the board were made clear by these revised principles.

TSE(the Tokyo Stock Exchange)compiled the *Principles of Corporate Governance for Listed Companies* in 2004. The contents are as follows.[12]

- Rights of shareholders
- Equitable treatment of shareholders
- Relationship with stakeholders in corporate governance
- Disclosure and transparency
- Responsibilities of board of directors, auditors or board of corporate auditors and other relevant groups

These principles have many points in common with the *OECD Principles*. They state that the corporate governance framework should protect rights of shareholders, ensure the equitable treatment of shareholders, including minority and foreign shareholders, and ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company. They also refer to active cooperation between corporations and stakeholders, effective monitoring management by the board, and the board's accountability to the company and the shareholders. The "comply or explain" principle was not required by either the TSE principles or the OECD's. However, it has spread in many countries since it was required by the LSE (the London Stock Exchange) in 1998.

After the TSE published the *Principles of Corporate Governance for Listed Companies*, the OECD then revised their own *Principles of Corporate Governance*.

4. Revised Version

After OECD published its *Principles of Corporate Governance* in 1999, Enron Corporation, which was one of the world's largest energy groups, went bankrupt in 2001. The corporation admitted that there had been a number of financial reporting irregularities over the period 1997 to 2000.[13] The full range of reasons for Enron's bankruptcy were publicized, from alleged insider trading, fraudulent accounting, and excessive financial leverage to aggressive trading positions in volatile energy markets and massive investment mistakes in large construction projects in Brazil and India.[14] Soon after, WorldCom admitted to misclassifying

[12] See http://www.tse.or.jp/english/listing/cg/principles.pdf.
[13] Wearing (2005), p. 67.
[14] MacAvoy and Milstein (2003), pp. 6–7.

substantial capital expenditures in previous periods.[15] WorldCom filed for Chapter 11 bankruptcy protection in 2002. After many corporate scandals were detected in the United States, Congress passed the Sarbanes—Oxley Act in 2002. In other nations, large corporate failures stimulated debate about corporate governance. For example, in the United Kingdom, the Review of the Role and Effectiveness of Non-executive Directors, which was called the Higgs Review, and the Audit Committees Combined Code Guidance were presented in 2003. The Financial Service Authority then revised the Combined Code on Corporate Governance. In Australia, ASX (the Australian Stock Exchanges) Corporate Governance Council published *Principles of Corporate Governance and Best Practice Recommendations*.

OECD established the OECD Steering Group on Corporate Governance to start the review and assessment of the *OECD Principles of Corporate Governance* and the survey on corporate governance. The group published *Corporate Governance: A Survey of OECD Countries*, which was composed of three chapters. The first chapter set out the forces which are driving governments to reconsider governance arrangement. Those forces were related to immediate pressures on policy arising from corporate scandals and large failures, financial market development, and the objectives to promote growth. The second chapter took up the issues leading from policy challenges; governments faced a broad choice of strategy in finding a balance between law, regulation, and self-regulation. The third chapter presented a thematic review of recent developments and emerging issues.

In the executive summary, they pointed out that an important function of the board was ensuring compliance with regulatory and legal requirement.[16] They mentioned that the principles of corporate governance in some countries call for a code of company ethics to be developed and disclosed by the board, which includes compliance.[17]

They also referred to corporate social responsibility, which was distinct from the stakeholder issues as treated in the *OECD Principles of Corporate Governance*.[18] They did not discuss issues of corporate social responsibility in any detail, since it was difficult to measure such a concept.

OECD published the *OECD Principles of Corporate Governance* in 2004, which was a revision of the original version. The contents are as follows.[19]

- Ensuring the basis for an effective corporate governance framework
- The rights of shareholders and key ownership function
- The equitable treatment of shareholders

[15] Wearing (2005), p. 83.
[16] OECD (2004a), p. 12.
[17] OECD (2004a), p. 98.
[18] OECD (2004a), p. 77.
[19] See OECD (2004b).

- The role of stakeholders
- Disclosure and transparency
- The responsibilities of the board

In the first principle, ensuring the basis for an effective corporate governance framework, the framework should promote transparent and efficient markets, be consistent with the role of law, and clearly articulate the division of responsibilities among different supervisory, regulatory, and enforcement authorities. In this principle, supervisory, regulatory, and enforcement authorities request to have the authority, integrity, and resources to fulfill their duties in a professional and objective manner.

In the fourth principle, the role of stakeholders in corporate governance, two provisions are added to the original version:[20]

> Stakeholders, including individual employees and their representative bodies, should be able to freely communicate their concerns about illegal or unethical practices to the board and their rights should not be compromised for doing this."
>
> "The corporate governance framework should be complemented by an effective, efficient insolvency framework and by effective enforcement of creditor right.

The former provision relates to whistle blowing, by which many corporate scandals are uncovered. The latter provision relates to an insolvency framework and the rights of creditors. These are important when large companies such as Enron go bankrupt.

There are some revised provisions in the sixth principle.[21] In the original version the board should ensure compliance with applicable law and take into account the interest of stakeholders; but in the revised version the board should ensure high ethical standards, being described as follows.[22]

> High ethical standards are in the long term interests of the company as a means to make it credible and trustworthy, not only day-to-day operations but also with respect to longer term commitments.

In this principle, the board has a key role setting the ethical culture of a company, not only by its own actions but also in appointing and overseeing key executives. The board should receive the information on illegal or unethical practices from stakeholders.

OECD recognizes the role of government for reforming corporate governance arrangements to regulate corporate behavior. On the other hand, OECD understands that the principles of corporate governance in many countries require companies to establish a code of ethics, some of which are stricter than applicable law.

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[20] OECD (2004b), p. 21.
[21] OECD (2004b), p. 24.
[22] OECD (2004b), p. 60.

5. Influence on Japan

OECD called for public comments on the OECD Principles of Corporate Governance Draft Revised Text, prior to its finalization. The Japan Business Federation (Nippon Keidanren) presented its views on the draft. Nippon Keidanren requested that work on the revision did not seek convergence toward a single model of corporate governance practice or patterns of action that are being followed in particular countries, and that the OECD should not act as a de facto regulator. On the other hand, Nippon Keidanren commented as follows.[23]

Although we endorse the content of section E, the term "ethics" indicates different notions depending on the country or region. Since we are concerned that there may not be a sufficiently shared universal concept of ethics, we maintain that this term should be removed.

Section C requires the board to adhere to "high ethical standards." We are concerned that there may be no sufficiently shared universal concept of "ethics." The current proposition of the Principles in terms of ensuring compliance with applicable law should not be modified.

Nippon Keidanren publishes the *Charter of Corporate Behavior* and recognizes that business ethics are important for business people. However, not all people interpret the notion of "business ethics" in the same way in Japan. Some do not like the term "business ethics," preferring to use other words such as "compliance." These comments by Nippon Keidanren did not reflect the revised principles.

The Japanese government seriously considered the execution of the whistle blowing system and the code of conduct for all companies. The Diet enacted the Whistle Blower Protection Act in 2004. The system is designed to protect whistle blowers from retaliation. The Japanese government recognizes its right to order companies to publish their code of conduct. However, these moves are not related to the OECD principles, but rather to the social background in Japan, such as the revelation of many corporate scandals.

In summary, the revised *OECD Principles of Corporate Governance* do not influence Japanese society to any great extent.

6. Conclusion

The OECD Secretary-General said that trust and integrity play an essential role in economic life and for the sake of business and future prosperity, it has to be ensured they are properly rewarded. He hoped that the *OECD Principles of Corporate Governance* helped to develop a culture of values for professional and ethical behavior on which well-functioning markets depended. OECD recognized the need to adapt implementation to varying legal economic and cultural circumstances, and adopted a non-binding principles approach.

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[23] See http://www.keidanren.or.jp/japanese/policy/2004/014.html.

The original *OECD Principles* influence the *Principles of Corporate Governance for Listed Companies* presented by the TSE in 2004. However, presently the revised *OECD Principles* do not have such a great influence on Japanese society, although there is an increasing effort toward reforming corporate governance regimes in Japan.

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