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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

[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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