EUIJ、Kansai 4th International Symposium
" Corporate Governance in the EU and in Japan"

## Table of Contents

# Forewords

Nobuchika Kaido
Vice-President, EU Institute in Japan, Kansai
Professor, School of Business Administration,
Kwansei Gakuin University

It is our great pleasure to have successfully held EUIJ, Kansai 4th International Symposium on "Corporate Governance in the EU and in Japan" at Kwansei Gakuin University on November 25, 2006. I would like to thank all the panelists for their contributions.

Since the 1990s, globalization has considerably influenced the societies as well as business administration in the EU and in Japan. Corporate governance in the EU and in Japan are also influenced by globalization and there is a tendency to accept the Anglo-Saxon model of corporate governance as a global standard.

Corporate governance – how and by whom large transnational corporations are controlled, – has become a very urgent question with respect to not only Europe but also Japan, as evidenced particularly by the profound revision of company law.

In the member states of the EU, the standards for corporate governance have become one of the liveliest topic of discussion. The participants of the symposium dealt with the issue from different angles – company law and business administration– and compared the European corporate governance model and the Japanese model with the Anglo-Saxon model.

Panelists were the experts of company law and business administration from Europe and Japan. In academic conferences in Japan it is unusual to discuss the experts of business administration with the experts company law together.

Therefore this symposium was a very good opportunity to discuss the issue of corporate governance from the point of company law and business administration.

As Vice-President, EU Institute in Japan, Kansai, I sincerely hope that a broad range of discussion held in this symposium will contribute the future research on the issue and the fruitful relationship of the EU and Japan.

**European Commission, ECJ and Corporate Governance – Company Law Rules between flexibility and binding statutes**

Jürgen Kessler, Professor, Fachhochshule für Technik und Wirtschaft Berlin

## 1. Introduction

If we try to analyze the different legal rules governing the broad range of company law within the legal order of the European Union Member States corporate governance turns out to be the main topic. From a European Commission point of view: "*A dynamic and flexible company law and corporate governance framework is essential for a modern dynamic, interconnected industrialised society*"[1]. For that reason EU institutions have taken a lot of initiatives in the fields of company law and corporate governance. Scrutinizing this development points at a small bunch of different aspects:

1. the freedom to choose every company form provided by the legal order of a Member State;
2. extensive harmonisation in respect of the regulation of securities markets and financial reporting by European Community Law;
3. the development of a small range of binding EC-rules on the subject of company law and corporate governance;
4. the development of non-binding Commission recommendations on the role and remuneration of executive directors or non-executive directors or members of the supervisory board, minimum quality assurance standards for statutory audits, and the independence of statutory auditors.

## 2. The freedom of establishment under the EU Treaty

Related to the first aspect it was and still is up to the ECJ to ensure the freedom of establishment by enforcing the constitutional liberties of the ECT. In so far Article 43

[1] Modernising Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward COM (2003) 284 final, p. 3.

(1) European Community Treaty (ECT) provides that "*restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be prohibited*". According to Article 43 (2) ECT the freedom of establishment includes "*the right …to set up and manage undertakings … under the conditions laid down for its own nationals by the law of the country where such establishment is effected*". The harmonisation of Member States company laws and corporate governance rules by means of directives is primarily based on Article 44 (2) g of the ECT. This Article requires the European institutions to attain freedom of establishment, "*by co-ordinating to the necessary extent the safeguards which, for the protection of the interests of members and others, are required by Member States of companies or firms within the meaning of the second paragraph of Article 48, with a view to making such safeguards equivalent throughout the Community*".

In respect of the interpretation of Article 44 (2) g ECT by the ECJ the Article includes two important grounds for the adoption of EU initiatives in the field of company law:

a) facilitating freedom of establishment of companies, that means the harmonisation of minimum requirements makes it easier for companies operating within the common market to establish themselves in other member states where the regulatory framework is similar;
b) guaranteeing legal certainty in intra-Community operations, where the presence of a number of common safeguards is key for the creation of trust in cross-border economic relationships.

According to Article 48 ECT "*companies or firms formed in accordance with the law of a Member State and having there registered office, central administration or principle place of business within the Community shall … be treated in the same way as natural persons who are nationals of Member States*".

**3. The "real seat theory" and the Competition of Company Laws within the EU**

In the past the "real seat theory" as applied by the German Supreme Court (BGH) and the jurisdiction of other Member States (like France, Belgium and Denmark etc) made it impossible – for example for a German enterprise – to incorporate by a legal form provided by other Member States, e.g. the UK Company Act. In so far traditional international private law of some European Member States, especially continental

Member States, excludes party autonomy by using residence (that means: "the real seat") as an objective and mandatory connecting factor. The "real seat theory" has been finally abolished by the jurisdiction of the ECJ enforcing the freedom of establishment as laid down in Articles 43 (2) and 48 ECT. In his judgement "Überseering" (C-208/00 Überseering (2002) ECR I – 9919) the court already confirmed that a "*necessary precondition for the exercise of the freedom of establishment is a recognition of those companies by any Member State in which they wish to establish themselves*". In the "Inspire Art"-case (C-167/01 Inspire Art (2003) ECR I – 10155) the court held that the application of national company law to a company established in another Member State can constitute a restriction of freedom of establishment as guaranteed by Articles 43 and 48 ECT. In the aftermath of the "Inspire Art Doctrine" "corporate law shopping" created some kind of competition between the legal orders of the Member States together with some kind of fear of "Delawarisation" in form of "a race to the bottom". At the same time this development worked as a trigger in respect of a broad bunch of company law reforms in the Member States.

So far as the second aspect of our introduction is concerned the abolition of the "real seat doctrine" by the ECJ simultaneously gave reasons for some kind of company law harmonisation at the level of EU legalisation. On 21.5.2003 the Commission issued a communication in respect of "*Modernising Company Law and Enhancing Corporate Governance in the European Union*"[2] and invented an EU action Plan, distinguishing the action in three phases (short term, medium term, long term), based on clear priorities.

In order to improve corporate governance the plan aims at:

1. enhancing corporate governance disclosure,
2. strengthening shareholders´ rights and
3. modernising the board of directors in respect of board composition, directors´ and remuneration and directors´ responsibilities.

**4. Corporate Governance disclosure**

So far as corporate governance disclosure is concerned, listed companies shall be

[2] COM (2003) 284 final.

required to include in their annual report and accounts a coherent and descriptive statement covering the key elements of their corporate governance structure and practices, which shall at least include the following items:

a) the operation of shareholder meeting and its key powers, and the description of shareholder rights and how they can be exercised;
b) the composition and operation of the board and its committees,
c) the shareholders holding major holdings, and their voting and control rights as well as key agreements;
d) the other direct an indirect relationship between these major shareholders and the company;
e) any material transaction with other related parties;
f) the existence and nature of a risk management system;
g) and a reference to a code on corporate governance, designated for use at national level, with which the company complies or in relation to which it explains deviations.

The Commission regards a proposal for a directive containing the principles applicable to such an annual corporate governance statement as a priority for the short term, so as to rapidly allow market pressures to be better exerted. The definition of these principles will properly take into account the related requirements in existing directives.

**5. Strengthening shareholders´ rights**

Shareholders of listed companies shall be provided with electronic facilities to access the relevant information in advance of General Meetings. This issue was in the past already addressed by the Transparency Directive (2004/109 of 15.12.2004), which essentially enables listed companies to use electronic means to inform their shareholders and contains specific provisions guaranteeing a timely access to regulated information when securities are listed in another Member State than the home Member State. On 05.01.2006 the Commission issued an additional Proposal for a Directive "*on the exercise of voting rights by shareholders of companies having their registered office in a Member State and whose shares are admitted to trading on a regulated market and amending Directive 2004/109/EC*". From a Commission point of view the existing Transparency Directive is not sufficient to attain the objectives of the action plan, for Article 17 of the Transparency Directive does not address the specific difficulties of non-resident shareholders in obtaining access to information prior to the general meeting. Furthermore the Transparency Directive focuses only on the information which issuers have to disclose to the market and thus does not deal with the shareholder voting process itself.

Furthermore for the Commission it appears that the main obstacle to cross-border voting are: the requirement to block shares before a general meeting (even where it does not effect the trading of the shares during this period) and difficult and late access to information that is relevant to the general meeting and the complexity of cross-border voting, in particular proxy voting.

The proposal for the Directive therefore pursues the following objectives**:**

1. Ensure that all general meetings are convened sufficiently in advance and that all documents to be submitted to the general meeting are available in time to allow the shareholders, no matter where they reside, to take a reasoned decision and to cast their vote in time.
2. Abolish all forms of share blocking. These should be replaced by a record date system to determine the entitlement of a shareholder to participate and vote in general meeting.
3. Remove all legal obstacles to electronic participation in general meetings.
4. Offer non-resident shareholders simple means of voting without attending the meeting (voting by proxy, in absentia and by giving instructions).

**6. Modernising the board of directors**

In key areas where executive directors clearly have conflicts of interests (i.e. remuneration of directors, and supervision of the audit of the company´s accounts), decisions in listed companies should be made exclusively by non-executive or supervisory directors who are in the majority independent. Following the statements of the Commission the requirements of independence should be enforced by Member States at least on a "comply or explain" basis. Nevertheless certain minimum of what cannot be considered to be independent should be established at EU level.

In respect of modernising the board of directors the commission according to the action plan 2003 issued two recommendations: the recommendation "*on the role of non-executive or supervisory directors of listed companies and on the committees of the* *(supervisory) board*" (2005/162/EC, OJ L 52/51) and the recommendation "*fostering and appropriate regime for the remuneration of directors of listed companies" (2004/913/EC, OJ L 385/55)".*

As so far as the role and the function of non-executive or supervisory directors is concerned the presence of independent representatives on the board, capable of challenging the decisions of management, is widely considered as a means of protecting the interests of shareholders and other stakeholders. In companies with a dispersed ownership, the primary concern is how to make managers accountable to weak shareholders. In companies with controlling shareholders, the focus is more on how to make sure that the company will be run in a way that sufficiently takes into account the interests of minority shareholders. Ensuring adequate protection for third parties is relevant in both cases. Whatever the formal board structure (one-tier or two-tier board) of a company, the management function should therefore be subject to an effective and sufficiently independent supervisory function. Independence should be understood as the absence of any material conflict of interest; in this context, proper attention should be paid namely to any threats which might arise from the fact that a representative on the board has close ties with a competitor of the company. In order to ensure that the management function will be submitted to an effective and sufficiently independent supervisory function, the (supervisory) board should comprise a sufficient number of committed non-executive or supervisory directors, who play no role in the management of the company or its group an who are independent in that they are free of any material conflict of interest.

According to point 13.1 of the recommendation in respect of supervisory directors "*a director should be considered to be independent only if he is free of any business, family or other relationship, with the company, its controlling shareholder or the management of either, that creates a conflict of interests such as to impair his judgement*". A number of criteria for assessment of the independence of directors should be adopted at national level, taking into account the guidance set out in Annex II, which identifies a number of situations reflecting the relationships and circumstances usually recognised as likely to generate material conflict of interest.

Following Annex II of the recommendation in respect of the "*profile of independent non-executive or supervisory directors*" independence is based upon at least the following:

a) not to be an executive or managing director of the company or an associated company, and not having been in such a position for the previous five years;
b) not to be an employee of the company or an associated company, and not having been in such a position for the previous three years, accept when the non-executive or supervisory director does not belong to senior management and has been elected to the board in the context of a system of workers representation recognised by law and providing for adequate protection against abusive dismissal and other forms of unfair treatment;
c) not to receive, or have received, significant additional remuneration from the company or an associated company apart from a fee received as non-executive or supervisory director;
d) not to be or to represent in any way the controlling shareholders;
e) not to have, or have had within the last year, a significant business relationship with the company or an associated company, either directly or as a partner, shareholder, director or senior employee of a body having such relationship;
f) not to be, or have been within the last three years partner or employee of the present or former external auditor of the company or an associated company;
g) not to be executive or managing director in another company in which an executive or managing director of the company is non-executive or supervisory director, and not to have other significant links with executive directors of the company through involvement in other companies or bodies;
h) not to have served on the (supervisory) board as a non-executive or supervisory director for more than three terms (or alternatively, more than 12 years where national laws provides for normal terms of a very small length) ;
i) not to be a close family member of an executive or managing director, or of persons in the situations referred to in points (a) to (h).

**"Corporate Governance in Japan" - From the Viewpoint of the Company Law -**

Takashi Aihara, Professor, School of Law, Kwansei Gakuin University

1. Introduction

I am a professor of business law at Kwansei Gakuin University and a director of its Institute for EU Business Law Studies. In both the capacities I am very much related to the object of this symposium and, I believe, Prof. Kaido kindly invites me here to report on the corporate governance in Japan. I would like to express my most sincere appreciation to the organizers, Prof. Kubo and Prof. Kaido and all the staff of EUIJ Kansai.

Now I would like to start my speech. First of all, I have to say it is rather difficult to understand fully what the corporate governance is. Even at present it may be an open question. You might have a very good understanding but the term has the various meanings in the different contexts. Therefore, to proceed to the further discussion, we have to confirm what the term of corporate governance means.

As stated in the brochure of this symposium, the questions of <u>who</u> govern the managements of gigantic modern corporations and <u>how</u> they do so have been the most critical issues in the long-time discussion of corporate governance. In addition, the "protection of stakeholders' interests" theory and the concept of corporate social responsibility have proposed the third question of <u>for whom</u> the corporations are governed. "Who, how and for whom" are the three points we have to discuss. If we can divide each element appropriately and grasp it clearly, I believe we will be able to fully understand what the corporate governance is.

My speech will consist of the four parts. First, I will comment on the roles of the company law for improving the corporate governance. Secondly, I will explain the current situation of corporate control in Japan by using some data. Thirdly, I will introduce some features of corporate governance reform made by the company law. Finally, I will discuss about what are the unique features of the Japanese corporate governance, compared with the Anglo-Saxon type. It will be a very difficult question to answer. I am hard to find the most suitable example for the comparison, but I want to shed light on the area of the hostile takeover bids and defenses against them because we are being faced with the needs to study this area with referring to the Anglo-Saxon laws.

## 2. Roles of the Company Law

From the perspective of company law, the corporate governance is the problem of how it should create the system or mechanism to prevent the abuse of power of the managements of companies. As was pointed out by a lot of experts, it is a very classical issue related to corporate governance. Although economic conditions change, it is an old but still new challenge we have to tackle.

As you have already known, Berle and Means published their famous book, "The Modern Corporation and Private Property" in 1932 and pointed out the separation of the ownership and control of the company. As for the private property, its ownership and control should essentially be inseparable. As to the modern corporation, however, they are separated and, as a result, the control by the management is established. The management does not have the ownership but the controlling power of the company. How could we prevent the abuse or misuse of power? The separation generates the control without the ownership. It means that the management controls the company owned by the others and that the corporate governance system is needed for protecting the interests of the owners. The company law has tried to regulate the managements of modern corporations. There might be more efficient corporate governance system. It has been one of the major objectives of the works amending the company law. In this context the new Japanese company law was taken into effect on May 1st, 2006.

The matter of concern of the company law is <u>how</u> it builds up more efficient corporate governance system and makes it work better. The law has little interest in the question of <u>for whom</u>. The reason is that, in terms of company law, the corporate governance system should be made up for shareholders and creditors of the company. It is self-explanatory in the world of the company law. Again, the role of the law is to create a system whereby the managements are regulated within the framework of the company itself.

In Japan, the company law had tried to improve the functions of the statutory auditors and general shareholders meetings. It was partially realized in its 1974 and 1981 amendments but had been the crucial issue in the 1980s. Then the interest of the company law moved to the board of directors as to establish the more effective governance system. The two functions of management and supervision have to be clearly divided. It comes to be the main point of the discussion for the efficiency of corporate governance these days. Under the Japanese company law, the companies can select one of the two board systems. One is so-called two-tier system, like the continental type. The company has the board of directors and one of statutory auditors. The other is one-tier system, like the Anglo-Saxon system. The company has the board of directors with three committees of appointment, audit and remuneration. The two systems coexist and the selection is vested over to the articles of incorporation.

Now let me move on to who is responsible for regulating the management of the company. For example, UK has its company law and voluntary code, such as the Combined Code, which requires the company to "comply with or explain". In Japan, we have just a law. There are no such the influential codes. The Corporate Governance Forum of Japan, which consists of the persons studying to make the Japanese corporate governance work better, has published the principles of corporate governance. The Forum are now preparing for the second version for revising the principles. They are only the principles which are announced to the public. However, companies are seemed to be passive to comply with them and it has little influence as a voluntary code. In addition, the Tokyo Stock Exchange has no substantial provisions of its listing regulation related to corporate governance. It has the set of corporate governance principles for the listed companies but it is acting as a guideline. The TSE has only the corporate governance disclosure rules.

We can say that we are quite dependent on the company law. In order to make corporate governance system work better, however, we have to respect the roles of voluntary regulations, I believe. It is important for the managements to have to some extent the autonomy on the corporate governance of its company. We should not ignore the elements of the autonomy and responsibility of the managements.

The annual conference of the World Council for Corporate Governance is held in London. There are a lot of discussions on corporate governance. At the earlier conferences we started out with the international comparison. Then, based on the comparison, we tried to create the good practices or models. Probably because of the economic rationality, as Prof. Kessler pointed out in the German corporate governance system, which has adopted a part of the US system, so is the case of Japan, we can find similarity more than difference. Now the discussion of the conference focuses on the education for directors. In Japan, we have the proverb saying that it makes no sense to create a statute of Buddha with no spirit injected. We have to think about how we produce the substance. In other words, we have to motivate and encourage the corporate managements to understand well the concept and purpose of the corporate governance and to regulate and to act autonomously.

In each country there are its own rules and practices. In comparison with them, I believe that the so-called soft laws, which mean the rules other than the laws enacted by the legislative body, are the essential part we have to abide by in Japan. Take the example of the UK again. The corporate governance principles have been established in the private sector. The managements have to comply with them or to explain the reason if they do not comply. That is what they call the "comply or explain approach". That's something we are very much interested in. The company law provides for the fundamental rules to set up and maintain the companies. For the listed companies, for example, the private sector creates the soft law on corporate governance. The term of "private sector" includes the managements of private companies. The "comply or explain approach" enables the managements to think, judge and do their own way to the corporate governance system suitable for their companies.

## 3. Current Situation of Corporate Control in Japan

### 1) Control by the Managements

The control by the management is supported by the stable shareholders of the company. They are long-term shareholders and form the silent majority. However, we can find some fluctuation of this foundation. It is the collapse of cross-holding. Please see Table 1 below. The ratio of share holding of the banks and insurance companies are notably reduced from 1999 to 2005. They are considered as main players of practice of cross-holding. On the contrary, the ratio of the foreigners has doubled during the same period. The banks and insurance companies are selling their holdings and the foreigners are buying them. Needless to say, the latter are not stable shareholders in general.

Table 1: Ratio of shareholding by the type of investor

Table1

| | 1999 | | 2005 | |
|---|---|---|---|---|
| | All | Section 1 | All | Section 1 |
| Banks (except Trust Companies) | 12.8 | 13.1 | 2.2 | 4.1 |
| Insurance Companies | 11.2 | 11.7 | 3.2 | 6.2 |
| Business Corporations | 23.7 | 22.9 | 19.8 | 23.6 |
| Foreigners | 12.4 | 13.0 | 22.2 | 25.4 |
| Individuals | 26.4 | 25.6 | 36.8 | 21.6 |

Source: *The 2005 survey on share distribution of Japanese companies*
1) The figures are given by the following calculation. Total number of shares held by each type of investor ÷ Total number of outstanding shares of "All" the companies and "Section 1" companies x 100 (%).
2) "All" means all the companies listed at any of the five local Exchanges (Tokyo, Osaka, Sapporo, Nagoya and Fukuoka).
3) "Section 1" means all the companies listed at the section 1 of any of the five local Exchanges. The section 1 is for lager companies including Nikkei 225 companies.

As mentioned above, the cross-holding has been gradually collapsed. In addition, the other statistic shows that the ratio of shares held by the stable shareholders has been reduced. Please see Table 2 below. These are figures presented by the company side. The table shows the ratio of the stable and long-term shareholders of the company: less than 40 percent, 40 percent level, 50 percent level, 60 percent level and others.

The numbers of companies falling into the segment appear on the top and the ratios (%) against the total number on the bottom. Compared with year 2001, such the numbers and ratios clearly decline in year 2005. The changes are 2.4 point down at 40 percent level, 1.5 point down at 50 percent level. Although the weight of stable shareholders has been reduced, however, the number of the companies more than 50 percent of whose shares are held by the stable shareholders is still quite high. It reaches more than 52.3 percent among all the companies. Therefore, we can say that the control by the managements of companies is certainly shaken, but still there are a lot of companies which continue to have the very firm foundation of the control by their managements.

Table 2: Ratio of stable shareholders

Table2

| ratio of stable shareholders | | ~39% | 40~49% | 50~59% | 60%~ | Others |
|---|---|---|---|---|---|---|
| 2001 | No. of companies | 267 | 381 | 539 | 556 | 270 |
| | % | 13.2 | 18.9 | 26.8 | 27.6 | 13.4 |
| 2005 | No. of companies | 406 | 319 | 490 | 523 | 200 |
| | % | 20.9 | 16.5 | 25.3 | 27.0 | 10.3 |

Source: *White Paper on Shareholders Meetings*
The total number of the companies covered by each survey is 2,013 in 2001, 1,938 in 2005. All the companies were listed.

2) Introduction of Outside Director

Under the Japanese company law, when a company selects the one-tier board system, it shall elect at least two outside directors. When a company selects the two-tier board system, except some specific cases, it is not required to have any outside directors but at least two outside statutory auditors. In practice, however, the companies with the two-tier board tend to be positive to elect outside directors. We can see there the good understanding of corporate governance of the managements.

The law defines the outside director as a director who has no experience of the director, officer or employee of the company or its subsidiaries and who must be a non-executive director. This definition is sometimes criticized because the director coming from the controlling company, related company or main bank is still considered as an outsider. Table 3 below shows the current situation of the outside directors. It is a comparison of March 2003 and March 2005. We can find the number is increasing and the independence is being strengthened. It is a good trend to proceed to the goal.

Table 3: Number and Independence of Outside Directors

Table3

| | 2003 | 2005 | Changes | |
|---|---|---|---|---|
| Number of Outside Directors | | | | |
| Number of Companies having Outside Directors | 589 | 878 | △ | 49.1% |
| Ratio (%) | 21.8 | 32.3 | △ | 10.5pt |
| Total Number of Outside Directors | 1,077 | 1,647 | △ | 52.9% |
| Number of Outside Directors per Company | 1.8 | 1.9 | △ | 5.5% |
| Subordination of Outside Directors | | | | |
| Coming From Controlling Company (%) | 21.2 | 18.1 | ▼ | 3.1pt |
| From Related Company (%) | 24.1 | 20.7 | ▼ | 3.4pt |
| From Main Bank (%) | 3.5 | 2.9 | ▼ | 0.6pt |

Source: Nikkei Research Report 2006-II

3) Active Voting by Pension Funds

Table 4 below shows how the voting rights have been executed by the Pension Fund Association (PFA). PFA is an association of the corporate pension funds. PFA also manages the money already contributed for the workers who have withdrawn from their corporate pension funds. PFA does not any monetary relationship with the government of Japan and so it is free to be an active shareholder. PFA is positive to voice up and to vote. There are public pension funds in Japan. For example, pension funds for obligatory national pension system, for national public employees and for local public employees. They also have the policies that they shall vote but there are some constraints as to how they vote because of their public character.

PFA has more freedom. Table 4 shows the voting results of PFA in 2006. The percentage of votes they cast against the proposals is 22.6. PFA has a set of guidelines for exercising voting rights. The voting is supposed to be in compliance with an applicable guideline. PFA did not unconditionally support the proposals presented by the management. It is said that PFA studies each proposals carefully and make its own decisions.

As far as the asset managed by PFA itself concerned, the in-house manager adopts the way of the index investment. As a result, the number of shares held by PFA per a single company is rather small. It is less than 1 percent of the total shares of the invested company. In spite of its size of investment, PFA has an influential body in the field of corporate governance and is surely one of the leaders of corporate governance reform.

Table 4: Voting Results in June 2006 of PFA for In-House Management

Table4

| Proposals from the Management | For | Against | Total | Ratio of Against (%) |
|---|---|---|---|---|
| Dividends | 670 | 114 | 784 | 14.5 |
| Change of the Articles of Incorporation | 647 | 216 | 863 | 25.0 |
| Election of Directors | 441 | 270 | 711 | 38.0 |
| Election of Statutory Auditors | 369 | 26 | 395 | 6.6 |
| Retirement Bonus | 220 | 253 | 473 | 53.5 |
| Increase of Renumeration | 300 | 0 | 300 | 0 |
| Stock Option | 146 | 39 | 185 | 21.1 |
| Election of Outside Auditor | 47 | 0 | 47 | 0 |
| Reorganization (Merger and others) | 19 | 0 | 19 | 0 |
| Others | 318 | 10 | 328 | 3.0 |
| Grand Total | 3,177 | 928 | 4,105 | 22.6 |

Source: *Pension Fund Association*

4. Some Features of Corporate Governance Reform

In relation to Prof. Kessler's speech, I would like to briefly go over some features of the Japanese company law.

First of all, the law places importance on the corporate governance disclosure. The Business Report, for which every company should prepare annually, is required to include a lot of items on corporate governance. As for the listed companies, the Securities Trade Law also requires them to report some major items on corporate governance in the Securities Reports to be filed by the company to the Ministry of Finance. Moreover, TSE mandates the listed companies to prepare a report on corporate governance. This is a part of its listing requirements. Although I'm not going into detail as to what items need to be disclosed in each report, I would like to point out that those items may not be something streamlined. The difference comes from the objective of each report, but there should be more harmonization in terms of the contents of corporate governance disclosure.

Secondly, the Japanese company law has the provisions that enable the companies to adopt the electric method for the communication with their shareholders. For the shareholders meeting, provided that the company gets the consent of each shareholder, it can issue the notice of meeting through the electronic means to those who have accepted it. In the same way as the notice, the electric voting is permitted. Whether the company adopts the electric means or not depends on the decision of the board of directors. The adoption is not compulsory.

Thirdly, the problem is the cross boarder voting. It is the exercise of the voting rights by the foreign shareholders. As I mentioned earlier, the ratio of the foreign shareholders is increasing. In 2005, the ratio of shareholding by foreigners reached 25.4 percent. That's a quarter. Therefore, facilitating the cross boarder voting by foreign shareholders is a challenge for us. TSE and Automatic Data Processing (ADP) have established a joint venture for that purpose. They set up the electric platform where the participating companies can provide foreign institutional shareholders with their translated proxy information and the foreigners can cast votes to the companies. The number of companies taking part in this project is around 150. More participation is encouraged but the cost is the matter.

Finally, I would like to refer to the modernization of the board of directors. Modernization may not be the appropriate term, but in any case, our new company law stipulates new corporate governance-related rules and regulations, including the definition of outside directors and the adoption of internal auditing system.

The sub-section 5 of the article 2 of the company law provides for the definition of outside director. As I mentioned before, an outside director is one who <u>was not</u> a director, officer or employee of the company or its subsidiaries and who <u>is not</u> an executive director, officer or employee of the company or its subsidiaries. Anyone who was in one of these positions in the past or is now must be excluded. The outside director is mandated when the company selects the one-tier board with the committees. If the company does not adopt one-tier board system, it must have an outside director in some cases. In addition, some companies have the outside directors voluntarily.

Pr. Kessler has discussed the independent directors in detail and pointed out the difficulty of defining them. The *raison d'être* of independent director is its independence against the management. The problem of what criteria or standard should be applied to secure the independence and to enhance the level of independence are critical. Again, in Japan, the definition of outside director is exposed to some criticism because Article 2 says only the company in question and its subsidiaries. Those who come from the controlling companies, related companies and the main banks are still qualified as outside directors.

In addition, even if the consultancy fee and advice fee are being paid to the directors, even if they have any economic relationship with the company concerned, they will be able to satisfy the requirement set forth in Article 2 and become outside directors. There is no limitation on the term of service of an outside director in Japan.

Defining properly an independent director is an important issue but it is also a difficult one. This mission is nearly impossible. Suppose the law sets the strict definition, you will be faced with the trouble to recruit an appropriate candidate. If the law focuses on formalities and puts too much emphasis on what needs to be established as a solid system, it will miss the substance and make things more difficult. It brings the situation like the proverb saying that that it makes no sense to create a statute of Buddha with no spirit injected. The spirit of independent director is the independence against the management. The mission is not to define an independent director strictly but to secure such the independence of the director. So as time progresses, I think, there will be a convergence of the definition of independent director in the future.

Different companies will incorporate the system in a different manner, so there may be some requirements differing from one region or one country to the other. But if they shared the same spirit, then I would assume that in the future we would come up with the same standard.

## 5. Hostile Takeover Bids and Defenses

Finally, the hostile takeover bid (TOB) is the last topic I would like to briefly go over. As you know, there was an incident about Nippon Broadcasting last spring, in spring 2005. People have started to discuss about the mechanisms of hostile takeovers and defenses. In Japan, a distortion about the stable shareholder structure may become a trigger of hostile TOB. It appears suddenly. So, it is an urgent matter for us to study the hostile TOB and to confirm the legality of the defenses.

The relationship between the management of company and the TOB initiator is the focus. Whether the management can protect itself or not is the question of whether the defense mechanism is legally permitted. As to this particular point, if the management takes some measures against a TOB, the question will come to be what the purpose of such act is. If it is not for the sake of protecting its own position as the management, then the next question will be what the purpose of the defense is. Can the answer exist? One answer is often made from the point of view of the corporate value. If the defense increases the corporate value, it will be permitted. The fundamental issue is, however, whether there is difference between a hostile TOB and friendly one. If someone proceeds to buy the shares of company in the stock market, it will be completely legal in spite of the purpose. As for the basic position on the question of how people should compete over the control of company, there will be difference between Japan and elsewhere like UK and USA, I think.

Last May the Ministry of Economy, Trade and Industry (METI) and the Ministry of Justice jointly published the guidelines of takeover defenses. They emphasize on the points of how the corporate value and shareholder interests are to be secured and how the defense mechanism against takeovers is to be designed and established. The former is the matter of substance and the latter is the matter of procedure. According to the guidelines, in order to prepare for the defense as precaution, the company shall set up the rules of how the management will do when someone acquires certain quantity of the shares. The rules have to be disclosed and approved by the shareholders. Then, in order for the defensive measure to be triggered, the management has to review whether the acquirer may have a successful plan to increase the corporate value and to secure the interests of the shareholders and enhance them. The management has also to review the necessity or the reasonability of the defense.

In the case of UK the TOB regulations are becoming even more stringent. As long as the acquirers comply with these rules, they can go ahead with their plan. In some EU countries we can see a combination of the stringent TOB rules and the general prohibition of the defense mechanisms. On the other hand, in Japan and USA, there are no strict regulations of the TOB procedure, but the defense mechanism on the part of the company is being focused upon. Under the guidelines set by METI, it is necessary to make a judgment of whether takeover defense is considered to be appropriate or not. One of the key issues is the corporate value. We have not the consensus for this yet; it is rather ambiguous. I believe we should continue to seek more appropriate solutions.

## 6. Conclusion

The Japanese company law was originally enacted after the laws of the continental Europe and then it imported the new provisions from USA after the world war second. Recently the Japanese legislators, scholars and lawyers tend to study the laws of USA and try to import them. As you can see from the example of the hostile takeovers, it is seemed that almost all people are looking at only USA. In other words, we have been following only the systems and solutions of the US laws. If so, where will the Japanese corporate governance be going? When we discuss the corporate governance, we should try to make a comparison of corporate governance, not only with USA but also with the EU countries.

I don’t know whether my presentation was an organized one, and I am very sorry that I had used up too much time allocated to me. Thank you very much for your attention. Prof. Iseda, thank you very much for your chairmanship. I will be happy if my speech contributes anything to the later discussion.

**EUIJ, Kansai 4th International Symposium**
**November 25, 2006, Kwansei Gakuin University**
**- Japanese-Style Management and Corporate Governance –**
**Hironori Yamada**

Introduction

It was two years ago that I retired from my position as Executive Vice President of Osaka Gas, but I continue to remain with the company as an advisor. While in active service, one of my responsibilities was to oversee corporate governance and compliance. By a fortunate chance, I currently teach a course on “enterprises and society” at this university as a part-time lecturer.

Today I consider it a great privilege to have been invited to this prestigious academic symposium, and I feel as if it may be rather presumptuous for someone like me to speak on such a special occasion. I suppose I have no choice but to do my best and leave things up to fate.

Before I begin, let me remind you that what I am going to discuss today is based purely upon my own personal views which stem from my experiences as a business manager, and is in no way meant to reflect the official opinions of Osaka Gas.

After a long period of time, we are currently experiencing a booming economy, which this month will have outlasted even the Izanagi boom that ran for fifty-seven consecutive months. Names retroactively applied to the major periods of business expansion in this country were taken from mythology, such as the Jimmu and the Iwato, which lasted for thirty-one and forty-two months, respectively. I’m very curious as to how they will go about finding a name for the ongoing business expansion that looks to outlast the Izanagi boom.

This ongoing business expansion does not come with a high growth rate as the Izanagi did, and therefore not many people are truly aware of it. But in fact it has been built upon the tough struggle during the country’s “lost decade,” and upon close examination I cannot help but think that the Japanese economy has come to a major crossroads.

The topic of my speech today is four-fold. I will begin by discussing the “contemporary significance of corporate governance,” and I will then talk about the “changes and evaluation of Japanese-style management,” followed by comments on “what must be done to create a human-oriented period.” I will conclude my remarks by expressing my opinions concerning “corporate governance in the knowledge-intensive society of the twenty-first century.”

## I. Contemporary significance of corporate governance

1. Corporate governance is being discussed from a great variety of viewpoints, but I would like to explain the contemporary significance of corporate governance by focusing on three major issues, namely, a company as a social entity, prevention of lax supervision over management and corporate misdeeds, and a governance system for the perpetual development of a company.

2. A “company” is given rights and obligations in human society just like a “natural person,” and is acknowledged by law as an independent entity. This is due to the fact that it was believed to be of service to our society to do so. As such, companies have played a role of a scale that individuals cannot possibly assume. In other words, it may not be too much to say that the concept of a “company” is the greatest system that human beings have ever invented.

3. As companies became increasingly large, however, there have been many drawbacks to this system. Between the 1950s and 1960s, when many cases of pollution-related diseases, defective products, and violations of human rights were reported, companies were first exposed to the daily criticism of society. Even today, there is a strong demand that companies be held socially responsible for scandals, such as bid-rigging and the leakage of private information.

4. Speaking of the relationship between a company and society, the fact that we have had many instances where it is unclear where responsibility for the social behavior of a company rests, has led to the impression that companies are some kind of social evil. In the case of a problem concerning a bank’s non-performing loans, for example, it is often an incumbent president, not the person originally responsible for the bad debts, who resigns because of it. Such practices make it difficult to determine where responsibility actually rests.

Now please allow me quote a well-known story. The sports gear manufacturer Nike was once boycotted due to the allegation that one of their subcontractors in an underdeveloped country was using child labor under long working hours during a portion of their manufacturing process. I have heard that the president of Nike responded by saying that he had known nothing about it, and furthermore that he could not guarantee that he would be informed of every single case of this kind should it happen again. I have to say this is not unique to Nike, but in fact is what you can expect from most large companies today, and it is certainly a very frank and unabashed statement.

5. I think companies as social entities have become too big. It is no exaggeration that, in many instances of corporate wrong-doing, the top management in question came to be aware of misdeeds just moments before they would become a major social problem. Normally, day-to-day decisions are made by those at the front line within a company and then approved by middle management. It often happens that when making decisions and approvals, these people do not realize that the issue could become a major problem of great social concern. A company without adequate control would eventually become a group of leaderless "monsters." How should we go about controlling a company that has grown so large? This is one of the most important issues when considering governance of a company as a social entity, which is the theme of today's discussions.

One of the great forefathers of the Japanese business circle by the name of Ichiryu Kikawada, who chaired the Japan Association of Corporate Executives, once commented on this back in 1961. Please allow me to quote: "Society should be the starting point when we discuss how an enterprise should be, rather than viewing society with the enterprise as the starting point." Half a century ago, Kikawada was talking about what is today known as corporate governance. I can only admire his great insight.

6. Let me now move on to the second point of this corporate governance exposition. One of the traditional discussions of this issue concerns "how shareholders should supervise enterprises and management" for the sake of "separation of management and ownership." Management is entrusted with a great amount of authority, and when that power is abused various misdeeds may occur, a prime example being the Enron case. When such wrongdoings receive a lot of publicity, the focus of "corporate governance"

shifts to fraud surveillance, and the Company Law in Japan has been amended in this direction.

7. When a company is born, it is established using the funds of its founder, who is also an owner-manager. It is therefore possible to ingrain the management philosophy into all of the company's employees while they remain a small operation. The owner-manager would expiate any corporate failure with his or her own reputation and assets. However, today's companies are almost absurdly enormous. A large number of shareholders have a stake in any company but, partly due to their limited liabilities, they seldom feel responsible for the decisions that their company makes. Most shareholders do not attend general meetings of shareholders because they lack any interest in what their company does. Thus, when a company causes a scandal, the shareholders do not feel any real guilt for the inconvenience that their company has caused to society, but instead are more concerned with the depreciation of their assets as the company's share prices plummet. This is the typical response of shareholders, and they certainly cannot be criticized for it.

Aside from some activist shareholders, individual shareholders are only interested in short-term dividends and share prices, and are almost invariably indifferent to the management of their company in general. As a consequence, top management is delegated huge power and responsibility. How can we prevent inadequate supervision over managers and their misconduct? This is the second point I would like to emphasize.

8. But corporate governance in terms of corporate management is not enough if it only means the prevention of misconduct by managers. If a company does not grow, the only issue that requires discussion is how earnings should be redistributed among stakeholders, which is certainly not a very positive thing.

9. In light of my own experiences, I think the single biggest duty of enterprise managers is to build a system for improving business performance and putting business on track through the efficient use of a group of human resources, while at the same time maintaining a customer-oriented mindset. I believe this point to be a matter of course, but it is one that is often neglected in discussions concerning corporate governance.

10. I believe that there are three fundamental roles in the governance of an enterprise.

The first is to encourage management to enhance the intrinsic value of the enterprise, and provide them with proper incentives in turn. The second role is to have the management coordinate and integrate the interests of stakeholders in order to improve the value of the enterprise as a social entity. The third is to select the best possible management when the incumbent management fails to fulfill their functions in achieving these objectives. The goal of enterprise managers is to consistently create corporate value and ensure the sustainable growth of a company. For this to happen, it is crucial that a kind of value-creating "DNA" be embedded within the organization. This is the third point of corporate governance.

II. Changes and evaluation of Japanese-style management

Moving on, I would like to go over the historical changes in Japanese-style management and evaluate them in terms of corporate governance.

1. Between the Meiji period and the early Showa period when modern industries were initiated in Japan, capitalists and wealthy persons would start a business, entrust management of the company to professional enterprise managers – Eiichi Shibusawa, Yataro Iwasaki, Zenjiro Yasuda, Ichizo Kobayashi, to name but a few - and entrust influential outside directors with the supervision of business management. In retrospect, their system is closely akin to what is currently considered to be the global standard.

2. The origin of what is generally known as "Japanese-style management" dates back to the period of "government-controlled economy," when the national mobilization system was put into place as the Pacific War intensified. Everything an enterprise did was placed under strict control, including purchasing, financing, recruitment, distribution, and investment, and national interests held precedence over all else for several years.

3. When Japan was defeated in the war, it was necessary to start from scratch. The easiest way to resuscitate the nation was to maintain a large part of the systems for controlled economy from the pre-war days, which was carried out. Despite major changes implemented by the occupation army, such as the dissolution of zaibatsu large financial combines and major amendments of labor laws, the national goal of "continuing the war" was carried on under the new banner of "national revitalization," which lasted until 1990s. This is what we call "Japanese-style management." In other

words, “Japanese-style management” is not part of the Japanese tradition, but rather a provisional system created during wartime but passed on even after the war’s end. There is no denying that in the end this system enabled Japan to achieve postwar rehabilitation at a pace unprecedented in world history.

4. Now then, “Japanese-style management” is often characterized by four major aspects. The first involves “forming a close-knit group” via a main bank system, cross-shareholding, and interdependence among enterprises, such as corporate groups. The second concerns “unique employment practices,” such as a lifetime employment system, seniority-order wage system, and enterprise unions. The third is “government-led maintenance of order,” such as bureaucratic control, harmonious public-private collaboration, and industry associations. And the fourth is “confidentiality,” typical examples of nonconformity in this respect being loose business accounting principles and poor disclosure of corporate information.

5. Now, how have these “Japanese-style management” practices been rated by the Japanese? From 1950 to around 1965, in the midst of a rapid economic growth the tone of argument was primarily negative, saying that “Japan is lagging far behind the rest. Its labor-management relations are too patriarchal and feudalistic.”

I am going to stray slightly off topic, but let me just say that I joined Osaka Gas in 1964, when the Olympic Games were held in Tokyo, and the company had a very considerate family allowance system. In the fourth year of my service, I passed a promotion exam and my salary increased substantially, which virtually served as an allowance for employees who have reached marriageable age. I also remember that inside the company there was a clinic and barbershop. It was almost as if salary and allowances were determined according to the number of the employee’s family members or his or her financial necessity at their particular stage of life, rather than individual performance. Back then, the whole company was like one big family.

The Japanese economy continued to recover steadily. By the 1980s, Japan had bounced back from its defeat in the war and regained its confidence. People began thinking that maybe Japanese-style management was not so bad after all. It was realized that the corporate culture of frequent peer consultation, made possible by the homogeneity of employees, provided the foundation for Japanese-style management. This was yet another source of confidence for the Japanese.

With the slowing-down of the US economy in the 1980s, the Japanese economy began to grow faster than the American economy. This led to the publication of many books for businesspeople in the US that analyzed Japanese-style management, saying that the US should learn from Japan, placing an emphasis on long-term growth and creating harmonious labor-management relationships. It was a time when the Japanese became rather haughty, believing this system to be the best in the world.

With the burst of the bubble economy in the early 1990s, however, the Japanese economy was slow to recover, causing a financial collapse that put all industries into difficult straits and eventually resulting in one bankruptcy after another. The Japanese-style management in which Japan had been so confident soon became nonfunctional, and Japanese confidence was as crestfallen as could be. Then it became predominant both in and outside of Japan to concentrate on the fact that Japanese-style management required drastic changes in order to meet global standards.

Now that the long-awaited economic recovery has been here to stay for several years, some have begun to question the wisdom of introducing the “global” standards of the Anglo-Saxon world to everything Japan does, while the doctrine of shareholder sovereignty has led to takeover bids and share purchases by funds. It appears that we are in a state of disorder.

6. Having survived with its various pros and cons, Japanese-style management has finally ceased to be functional. During what has come to be called the “lost decade,” individual elements of Japanese-style corporate governance underwent a major transformation. There are two major environmental changes that have expedited this process and one of them is globalization. After the Cold War ended, the capital market expanded. Another was a significant change in the rules of the game. In the beginning, the prolonged recession put the financial sector, which had previously been protected by regulations, into turmoil. With the government being at a loss as to what should be done, one enterprise after another slipped into a structural deficit, and in a desperate move these enterprises did whatever it took to survive.

These two environmental changes brought about major transformations of individual elements of Japanese-style management, the first one being an unwinding of cross-shareholding. With the exception of zaibatsu groups, shares are cross-held between non-financial companies and financial institutions, or their major long-standing customers when the former ask the latter to purchase their shares at the time of a major capital increase, or vice versa. Therefore cross-shareholding is not usually intentional, but instead merely the result of long-term friendly relations. There is no agreement whatsoever as to how many shares each should hold. At least in my experience I have never known of anything like a "cross-shareholding agreement."

In a desperate move to satisfy the BIS capital adequacy requirement, Japanese banks left this interdependency behind, recovering loans and selling many long-term company shares. No longer obliged to own bank shares, non-financial companies on the other hand, sold any shares that did not bring them any dividends. The total volume of non-financial company shares held by financial institutions has been halved over the course of the last ten years. Non-financial companies procure funds directly from the market by issuing corporate bonds without the use of bank loans, and the term "main bank" has already become passé, at least for large companies. Incidentally, Osaka Gas has virtually no long or short-term borrowings from private banks.

Another change took place concerning employment practices. Long-term employment acted as a hindrance to companies when they became trapped in a long spell of low profit years, and so they attempted to reduce fixed costs through a voluntary retirement program that offered a large addition to employees' retirement allowance. In order to survive, a large number of enterprises had to make tough choices despite their wish to retain technological prowess for future growth and maintain friendly labor-management relationships. Still many others lowered the break-even point by replacing regular employees with temporary ones.

The third change that took place was the disclosure of corporate information. As a part of the globalization process, many of the shares once held by banks and non-financial companies changed hands to overseas investors. Unlike Japanese shareholders, these investors demanded that their voices be heard. The California Public Employees' Retirement System of the US strongly criticized Japanese enterprises for their poor disclosure and inward-looking management culture, forcing them to take action. The legal system was then amended in favor of this trend.

The general meetings of shareholders of Japanese companies were often hailed as a prime instance of shareholders being completely disregarded. As legal systems developed, however, *sokaiya* corporate racketeers became almost extinct, and all companies are now willing to disclose their corporate information and give scrupulous explanations, and also spend more time on those meetings. Also gone are the general meetings that were arranged to go off without a hitch with help from employee shareholders.

When I was the Senior Managing Director and Executive Vice President of Osaka Gas, I was in charge of three general meetings of shareholders. I asked all of the directors to use videos for their presentations so that the audience could better understand, explain any current managerial issues even if no one asks about them, and kindly answer any minor questions. Of course, we did not close the Q&A session due to time constraints. I believe that other companies are more or less the same in this regard, and it would seem that things have changed completely.

The fourth change concerned various amendments to the legal system. Because of its ongoing globalization, Japan can no longer stick to its unique ways of getting things done. Following the period of few amendments in the postwar era, the commercial law of Japan has undergone major amendments almost every year since 1997, and has finally been renewed as the Company Law just recently. As you are aware, related laws and principles, such as the Securities and Exchange Law and corporate accounting principles, were also amended dramatically.

The fifth change was a board of directors reform, which is the focal point of corporate governance. In response to the criticism that board meetings have been reduced to a mere shell of their former existence, companies are now introducing a corporate officer system and reducing the number of directors, so that they are able to hold more substantial discussions at board meetings.

That being said, many enterprises still hold fundamental doubts concerning the independent director system. They question whether they will truly be able to fulfill their duties as director from outside of the company. This concern has been aggravated since independent directors were unable to prevent misconduct at Enron and WorldCom, and some of Japan's leading companies like Toyota and Canon are opposed to this system. Although nearly half of the listed companies in Japan have independent directors, I do not think that they are fulfilling their original purpose of checking management's decisions. It remains to be seen whether this system will actually take root in Japanese soil or not.

I myself act as an independent auditor of a certain company on a part-time basis. They send me monthly reports and provide me with detailed explanations at board meetings but, not being there personally to witness everything that goes on, it is quite difficult to judge how minor or serious an issue actually is. But if I should decide to serve as a quasi-full-time auditor because the company wishes to allow me to become better acquainted with the realities of the company, I may end up losing my independence and becoming bound by all sorts of constraints. Then I may not actually qualify as an "independent" auditor, and the same holds true for independent directors.

A judicial decision concerning a class action filed on behalf of Daiwa Bank shareholders has had a major psychological impact on enterprise managers. The individual managers were told to pay a total of nearly 100 billion yen as compensation for damages. This shocking decision must have made board directors realize their heavy responsibility, and significantly affected the behavior of individual directors, who had simply done what their chairperson or president had told them to do.

As for me, this news made me appreciate anew the importance of being able to account for how I formulated a decision, by using supporting data and following the decision-making process of the company when making a big decision and referring it to the board meeting.

The other day, there was a district court decision in the US concerning Enron's illegal accounting case. The sentence given to the CEO was twenty-four years of imprisonment with a fine of 5.3 billion yen. If this had been in Japan, it would most likely have been an imprisonment of several years with probation at the most severe. Just as expected, America is very strict on such incidents. Knowing that this will affect the assessment of culpability in Japan sooner or later, the business circle here was rocked by the news of this sentence.

Of the issues that I mentioned at the outset, that of "supervision over enterprise managers" has made significant progress owing to the development of legal systems and social pressure.

## III. What must be done to create a human-oriented period

I would like to move on to the third theme, which concerns a “human-oriented period.”

1. Created prior to WWII and maintained for long after the war’s end, the framework of Japanese-style management has been shaken up considerably between the expansion of competitive markets and borderless economy and a prolonged recession, to become a completely different system. However, the fundamental aspect of “interpersonal relationships” underlying the Japanese culture has remained intact. Take the “practice of long-term employment” as an example. It is true that at one time there were many cases of hiring non-regular employees and encouraging senior employees to retire early. As the economy has begun to recover recently, however, there has been a backlash from companies who put non-regular employees on their payroll and rehire retirees on a part-time basis.

The “Company with Committees” corporate governance system, which was created to separate management from ownership, does not seem to fit into the Japanese corporate culture and is thus unlikely to gain wide acceptance. Independent directors are increasing in number, but in many cases they hold these positions in name only. Many are of the opinion that it is far better to have a director originally from within the company, who has long served the company and knows it and the industry like the back of their hand, rather than an independent director who is not really sure about what the company is actually doing.

Introduction of the American practice of performance-based wage systems once enjoyed a boom, but is currently losing momentum. It is said that this is because many enterprises introduced the system to find that it not only fails to “enhance employees’ motivation for work,” but also adds to employee dissatisfaction and anxiety. Thus, many of these enterprises have had to either overhaul or scrap the system completely. With the performance-based wage system, it often happens that one person’s given target is more challenging than another’s, and that the measure of individual performance is unclear. Such being the case, remuneration fails to serve as a symbol of one’s talent and true merit performance.

Speaking from my many years of experience, if a company hires one hundred white-collar workers, twenty of them are usually capable of demonstrating excellent performance regardless of their assignment, another twenty are a failure no matter where they are assigned, and the remaining sixty change places with each other at any given time owing to their chemistry with any given assignment or bosses, or for family reasons. In Japan, workers cannot be dismissed so easily, and liquidity in the labor market is quite low. Therefore it is important to come up with solutions that will revitalize each of these sixty people. In other words, a common target should not be set for everyone to shoot for and then decide the ranking. Rather, management should try to help each and every individual in order to hone their talents, by giving them assignments that are believed to best suit their talent and character.

2. Times are changing fast, and competition is becoming increasingly tough. To survive, it is necessary to lower costs by outpacing competitors in the introduction of new technologies, or increase profits by developing one-of-a-kind products. Needless to say, "sources" of profits can only be created in the human mind, and no matter how financially rich you are, you cannot control all the knowledge and talent within an individual human brain. Clearly, the central component of economy is the shift from "money" to "humans."

When I was general manager of Osaka Gas some ten years ago, I was given the concurrent position of CEO of an American engineering company, which had been established as a part of the company's overseas business. As you can easily imagine, engineering is clearly brain work, and I had great difficulty in motivating the demanding American engineers to produce results. In the US, it is far easier to lay off engineers who lack enthusiasm than it is in Japan. On the other hand, there is always the risk of outstanding engineers being head-hunted by competitors.

A typical example of this was Matsushita Electric's acquisition of the American motion-picture company MCA in 1990. After the acquisition, Matsushita met with a strong opposition from American society, which blamed Matsushita for "buying out American spirit." In addition, some directors and production staff quit the company to establish another, and so Matsushita was forced to sell MCA to a major beverage manufacturer. This illustrates that a company is comprised of people and is worthless without them.

3. This leads me to believe that "human creativity" will be essential to the success of any company. The key issue that any company must address is how they can create and support a team that is capable of making a positive differentiation from competitors and

continuing to do so at a pace faster than the ever-shortening product life cycle.

Toyota helped its employees to develop their ability to think and identify problems. Matsushita Electric introduced a management scheme that enhances staff motivation and ability via flat organization and web-based communications. Takeda Pharmaceutical created a system that delegates power to persons of high caliber, and expanded its scope to non-Japanese employees. All of these enterprises are excellent Japanese companies.

Curiously enough, companies that survived the Japanese economy’s “lost decade” and continue to enjoy success are Toyota and Canon, who did not disregard the painstaking, down-to-earth practice of maintaining interpersonal relationships. It is highly ironic that companies like Sony and Hitachi, who introduced an American-style corporate governance system, are still performing poorly. Here we can learn the lesson that a company cannot control human minds.

4. The proposition of to whom a company belongs has caused a major controversy following the series of M&A attempts conducted by Takafumi Horie, former president of Livedoor, and the Murakami fund. Some say that companies belong to shareholders, while others insist that they belong to employees, and still others believe that companies belong to society as a whole. In my personal opinion, American-style enterprises tend to place emphasis on “stock ownership,” whereas Japanese-style enterprises emphasize the fact that “all corporate activities are conducted by managers and the employees under their supervision.” However, this is certainly not a case in which one is right and the other wrong.

5. Within Japanese enterprises, however, the fact is that the “logic of the capital market” has long played second fiddle to the “logic of an organization.” The times certainly have changed. What is now crystal clear is the fact that you cannot hope to survive in the global capital market if you fail to achieve a well-balanced governance structure, in which you pay close attention to the “logic of the capital market” on one hand and to the “communal logic within an organization” on the other.

6. One of the biggest lessons of the twentieth century was that it will be sometime before a system superior to the capitalist system is developed, although that system is certainly not without various flaws and contradictions, such as economic gaps and

recessions, environmental destruction, and the worship of money. Vast experiments conducted by Russia, China, and other socialist countries have proved that socialism only serves to suppress people's freedom and does not make them happy. It is only natural that our pursuit of freedom revitalizes society, but it does not come without its negative aspects. We should not deny capitalism as a whole simply because of its few flaws.

7. The biggest system under the capitalist regime then, is the company. Companies leave the hands of their owners, a.k.a. shareholders, and managers are entrusted with every single action they take. Enterprise managers are therefore obliged to act "ethically" with companies, in the form of duties of loyalty and care. It is the ethical values of enterprise managers that compensate for any flaws and contradictions. I would venture to say that without the support of these ethical values, no society is worthy of being called a civil society.

8. One of the hottest issues concerning internal governance in Japan is the J-SOX act, which is the Japanese equivalent of the US SOX Act, established in the wake of the Enron and WorldCom cases. At present, Japanese authorities are said to be developing concrete standards by improving on the deficits of the US SOX Act.

The US is a litigious society, and it is a part of common practice among American companies to always keep evidence beforehand in case someone should sue them. The drawback of this is that it may give birth to the mindset that you can do whatever you want so long as there is no evidence legal infringement. As pointed out earlier, today's companies are entirely too large, and their influence has become proportionally enormous.

Some people seem to believe that they may do whatever they want so long as they do not infringe on any laws, and that whatever they do is justified only if they manage to produce evidence of non-violation. But are these people gaining social respect? One of the assertions of Livedoor's Horie was that he did not infringe on any law. Let me remind you that any law is established retroactively, and one can command respect only with superior "moral character," which comprises a higher level of integrity and humbleness within society. If we assume that a company is given the status of a legal person only when it is acknowledged to be of service in society, its "behavior" must fulfill stricter requirements than those for individuals. Perhaps this is the pivotal point for the sustainable growth of enterprises.

Allow me to discuss two recent cases. The first case is Kubota's spontaneous offer to pay consolation money to the victims of mesothelioma caused by the asbestos used in their plant. The relationship between asbestos and the deadly disease had not been established for many years, and it was perfectly legal to use asbestos at their production lines. Nevertheless, they decided to compensate residents in the neighborhood for damages. They say that they complied with standards for using asbestos and strongly encouraged their employees to apply for work-related accident compensation, but still the fact that their employees and residents have suffered is simply too serious an issue. I was told that they had to overcome emotional conflicts – is this tantamount to admitting their responsibility, or will Kubota be seen as trying to avoid case settlement by paying out money instead? - before eventually reaching their decision.

The second case is that of contaminated soil at condominium site, which led to resignation of top managers of Mitsubishi Estate and Mitsubishi Materials. When they developed the plot, the Agricultural Land Soil Pollution Prevention Law was not in place, and so there was no law in existence that required them to examine for soil contamination. Likewise, soil contamination was not among the list of important matters whose disclosure is required by the Building Lots and Buildings Transaction Business Law. However, they were condemned by society due to the fact that, although they did not violate any law, their oversight was unforgivable.

Another case of this kind is Matsushita Electric's voluntary recovery of defective kerosene fan heaters. They even went so far as to go beyond their legitimate obligations to collect the products that they had sold in the past.

## IV. Corporate governance in the knowledge-intensive society of the twenty-first century

I would now like to move on to discuss the last theme for today, which is "Corporate governance in the knowledge-intensive society of the twenty-first century," followed then by my conclusion.

1. As mentioned earlier, human capital plays a pivotal role in the Japanese method of corporate governance, but it takes sometime before this human capital begins to

function efficiently. Once, an American rating company lowered their rating of Toyota due to the fact that they maintain a lifetime employment system. The time span over which the stock market assesses the value of an enterprise is “the present time plus the foreseeable future, several years ahead at the longest,” whereas it takes much longer to develop human talents and foster good teamwork.

A research study conducted by Professor Kudo of Waseda University reported that “37.6% of fund managers in the US foresee the future of a company as longer than one year ahead, but this percentage was only 5.4% in Germany and 8.2% in Japan, and that their Japanese and German counterparts look only several months ahead.”

Take the example of Sharp. They began developing LCDs in 1973, but it was not until 1987 that they came up with the first 3” color TV set model. Their development efforts came to fruition only several years ago when they successfully launched their large-sized LCD TVs. Theirs is a long project that has lasted over thirty years. Likewise, Osaka Gas began developing fuel cells in the 1960s, but it should be some time before their efforts bear fruit. Now the main problem is that a major gap exists between the “length of time” over which enterprise managers and employees foresee the future of a company, and the “length of time” over which the stock market assesses the future of the company.

2. Recent trends show that many individual shareholders buy and sell shares on the Internet and that domestic and overseas funds make frequent transactions, which has resulted in a shorter share-holding period. It is not surprising for shares to be sold within only a couple of years. Some buy and sell shares on the same day, and they too are counted as shareholders.

Indifferent to any continuous increase of corporate value over the mid and long-term, some shareholders demand that the company increase dividends, discontinue business diversification and R&D projects if they are not 100% sure of their success, and sell more of their idle assets, etc. But is it right for them to become involved in making decisions that are a matter of life and death for an enterprise, such as the merger and acquisition of the enterprise?

3. You might remember an attempt by the Murakami fund to take over Hanshin Electric Railway shares. Mr. Murakami insisted that a company belongs to its shareholders, and

so the mission of an enterprise manager is to maximize shareholder value, namely, share prices. Public opinion was dubious about this, saying that "The Murakami fund does not appear to be ready to take social responsibility for managing railway services. We could be threatened with another major accident like the one with JR in Amagasaki," and "Is it alright to leave directors with no experience in railway service management to manage the company?" It was feared that technological stock and human organizations – two major pillars of social responsibility for railway service management - would be destroyed as a result of a money game. As it turned out, none of these concerns materialized as the Hanshin Electric Railway was acquired by Hankyu Corporation, another experienced railway operator. Had Mr. Murakami been arrested by the judicial authorities a bit later, Hanshin Electric Railway would have been sold to a global financial capital.

The Murakami fund created a stir within the business community of Japan, where shareholders are not given due regard and managers are allowed to do as they please, thus playing a major role in setting Japanese-style capitalism straight. As it turns out, however, what they did was to simply pick out promising stock from many different sectors, rather than making any innovative proposals concerning the future growth of a company. They did not have much to offer to the company, and attempted to buy it out in the hopes of benefiting from reacquisition by the company. What supposedly began as a shareholder's constructive proposal for future growth of the company became a means to sell off shares before the price dropped.

4. Partly due to the emergence of this kind of shareholders, enterprise managers in Japan are becoming increasingly shortsighted, only paying attention to share prices. As long as share prices are increasing, they do not have to worry about their job security. However, higher share prices do not necessarily mean an increase in corporate value. Too much attention to share prices can serve to confuse enterprise managers, who then desperately try to reduce costs while refraining from making long-term investments in research and development, since they do not produce immediate profits.

5. Such shortsighted tendencies can affect corporate culture. I am afraid that, behind the recent recovery of corporate earnings, the "distance between a company and its employees" has only increased. In the past, employees rejoiced at seeing their company's performance improve. Better results revitalized employees and enhanced the sense of unity between the company and its employees. However, I wonder if

employees of a company whose performance has improved are sharing the same pleasure that they did in the past? Many companies are giving precedence to the “results of a foreseeable short term” over an “increase in mid and long-term competitive edge,” and are busy curtailing long-term investments that do not promise concrete returns, reducing costs in an unreasonable manner, forcing employees to do more overtime work as a result of downsizing, and sacrificing fringe benefits. I hear that employees at these companies are growing dissatisfied and losing motivation, as they feel that they are being “forced” to work.

6. The tendency of managers to become shortsighted poses a major problem for the Japanese economy’s future. In the past, the management style of Japanese enterprises was characterized by their long-term orientation, and there is no denying that this was an “unconscious long-term orientation.” Protected by such systems and practices as cross-shareholding and the main bank system, enterprise managers did not have to worry about the security of their position, and thus could put off any problems indefinitely. Now that we are about to enter a “human-oriented period” and a “period when it is important to exist in harmony with society,” enterprise managers need to establish a “conscious long-term orientation.”

7. Of course, the corporate culture of disregarding shareholders is another source of major concern. History has shown that any organization without effective governance will inevitably become corrupted. From the Mitsukoshi and Sogo cases of the past, to the more recent Seibu Railway case, the list of major incidents where managers’ ability to lead was questioned goes on ad infinitum.

8. And so, I am wondering if there is any way for the interests of shareholders and enterprise managers to be aligned with each other. Apparently, business management is moving towards a human-oriented period. Shortsighted managers may misdirect their organizations, but my concern is that shareholders are becoming increasingly shortsighted. There is even the risk of them treating a company simply as an object and cashing in on a company’s value in society. Nothing is more frightening than money without a philosophy behind it. It reminds me of the Thailand Baht crisis which was triggered by a hedge fund.

9. Fund managers buy out shares of a certain company with the money collected from a large number of good-intentioned individuals, but they might sell out those shares for

immediate profits, which can result in discontinuation of business. There is nothing illegal about this, but in so doing they deny various functions that the company has played in society, resulting in social confusion. Based on an economic freedom that assumes a fair balance, financial capitalism is seemingly compatible with interests of a civil society. But a civil society has many different kinds of value that cannot be converted into money, and these kinds of value assume greater importance as societies become more materially affluent. Market fundamentalists believe in the "invisible hands," but so long as they place absolute trust in the value of money, the social roles of a company are nothing more than a byproduct and a tool with which profits may be generated. The principles of profit pursuit do not guarantee social roles that are always welcome.

10. Fully aware of this, some companies have begun offering complimentary gift programs that favor long-term shareholders, who supposedly assess the company's value over a longer period. For example, Keihin Electric Express Railway and Keisei Electric Railway give out more complimentary tickets to shareholders who have owned their shares for three years or longer than to their other shareholders. Dowa Holdings on the other hand, announced a new program in October 2006 whereby new shares would be allotted to shareholders who have held their shares for at least three years.

Before I conclude my speech, let me share some of my ideas concerning increasing long-term shareholders. Firstly, regulations must be changed so that companies can amend their articles of incorporation and introduce a system of conferring more than one vote to shareholders. For example, one could confer the right to two votes per trading unit to shareholders who have held the company's shares for, say, three years or longer after stock transfer, and three votes to those who have held the shares for ten years or longer. The second suggestion is to provide tax-free preferential treatment to employee stock ownership. And third, tax exemption or reduction on capital gains from the sale of long-held shares should be implemented.

I am just a businessperson and not an expert on company law or theories of tax law, but I can easily imagine that, if we were to realize these ideas, it would become difficult to maintain theoretical consistency between different systems and make adjustments with other policies. I know that France has a system of conferring the right to more than one vote to shareholders, but this has to do with the very basis of capital market theory. Some may criticize and claim that it is merely an idealistic thought, but I firmly believe that the question of how we can combine financial capital that has become too large and the benefits of society poses an issue that is necessary for the whole world to address as we set out into the twenty-first century.

**“Corporate Governance in Japan”**

Mitsuhiro Hirata, Professor, Seijo University,
Professor Emeritus, Hitotsubashi University

**Mitsuhiro Hirata**: Thank you for your kind introduction. My name is Hirata. More than 50 years ago, when I was a student, I came here to this campus for the first time. I was overwhelmed with the beauty of the campus and I am therefore very much honored to be given this opportunity to deliver a presentation and I thank you very much.

The topic given to me is to discuss corporate governance in Japan from the point of view of the management. So please refer to the handouts, and I would like to talk from the business administration point of view.

I am going to discuss three issues and points. The first point is what problems we see around the issue of corporate governance in Japan, that is, why corporate governance has become an issue in Japan. The background and the reasons why are what I’d like to discuss in the first of the three sections of my presentation.

Secondly, I would like to talk about the corporate governance reform in Japan, which is under way. If I go into this in detail, the time is not enough for me to go over them, so I will just put some emphasis on some of the aspects. I will focus on the early part of the history of the reforms and also I will highlight the recent trends.

And thirdly I will discuss the future direction of the corporate governance, the direction I would like corporate governance to take in the future and what could be the possible direction. These are the things I’d like to discuss.

And of course I will focus on Japanese companies. Companies in other countries, it’s not that I’m going to ignore them, but rather I would focus on Japanese companies. And I will also limit my talk in terms of the views relevant to my talk. It was towards the end of the 1980s that the points raised with regards to corporate governance in Japan, so the period I will cover will be between 1990 and 2006. Although it hasn’t been completed, I would like to go over the past 15, 16 years.

As you can see, I have a rather broad definition of corporate governance. The first point is compliance. And compliance is paired with the second definition of governance in the narrow sense of the word. Compliance is the basis or the precondition I would assume of the governance. And the role of compliance is to deter corporations from going into scandals as people believe, and by doing that they aim to put a healthy business administration and management. When the problem of compliance is raised, it means that there is unhealthy management of the enterprise and the role of the compliance is to make it healthier.

And then the governance, in the narrow sense of the word, means to promote the competitive ability, that's what people believe. And through enhancing the competitiveness of their corporation what it aims is to have an efficient management. When the management is not efficient, the idea is to make it better in terms of efficiency, and that is expected as the role of the governance in the narrow sense of the word.

Although the European speakers did not mention it this morning, in the EU, I would assume that compliance is an obligation on the part of the companies, so the EU leaders I understand strongly believe that compliance is not a part of the governance, but I am not for that argument. That is, compliance and governance are to go hand in hand, and only when we have them paired corporate governance comes into being.

And next, when it comes to what problems we see with regards to corporate governance in Japan, I would like to classify these issues and problems into three categories. The first is the issues found in the 1990s. Earlier the guest speaker talked about the lost decade. In the 1990s the economy was in recession; corporate governance-related matters were quite handy in discussing various matters. Under those circumstances I think commonalties among the market economy industrialized companies, one is that the shareholders are marginalized from the management. And governance was highlighted as an issue of the large companies, so governance was not an issue of SMEs. From the historical point of view, the managers of large companies were not respecting the views of the shareholders in terms of its management and the shareholders felt that they are isolated or separated from the management.

And the second point is when the corporations act, you would consider corporations as a part of the society. So you need to consider the power balance of different shareholders and different stakeholders. You need to consider the power balance of the stakeholders when managers manage the company. That's point two. That's the second point of the commonalty of industrialized companies in the market economy.

The third point of commonalty is that institutional corporate investors, particularly in the United States, became shareholders with voices. They started to take part more in the management. And in relation to that the dormant shareholders were suddenly awakened and started to speak up.

The fourth point perhaps is the point that only myself has been shedding light on, is that there is an over-expectation of the role of the corporate governance as it will inhibit or deter any corporate scandals. Even now, however, some researchers and practitioners and managers still believe in the fact that corporate governance could deter corporate scandals.

These are the common reasons why corporate governance started to attract attention, but there are some Japan-specific issues and these are the five features found in Japan. One is that after the bursting of the bubble economy, in relation to that we saw surfacing of various corporate scandals. You might find it rather unusual to see these scandals popping up one after another just because of this recession, but in the past, in the times before that, you had those scandals underground so to speak. But after the recession started, they came to the surface. So it's not that the scandals actually took place during the recession, it's just that they were hidden underground and people were unaware of them. They were talking about the bubble economy, they were talking about globalization, they were talking about corporate strategy and Japanese-style management to be good, for all these reasons people were just unaware of these scandals.

And the second point is that because of these difficulties, their corporate performance declines, and shareholders, employees and other stakeholders had some negative impact on that. And the class action is another possibility on the part of the managers when they fail to properly manage the company. The corporate managers wanted therefore to minimize the risk of their failure. So that's another reason why the corporate governance attracted attention in Japan.

Another reason is that you would need to be more agile and flexible in managing the company and looking into the shift of operations.

And finally, in the 1980s Japanese type of management was highly appreciated from overseas. Japanese managers were all respected for their talents and capabilities. But during the recession that followed, there was very severe criticism and there was suspicion over the efficiency of Japanese type of management and many people questioned its positive aspects. So these Japanese company-specific issues have led to had people highlight on corporate governance.

In the early part of the twenty-first century, it’s not that all these issues have disappeared; some did disappear. Recently Japanese companies have rejuvenated and under these circumstances the reason why I focus on this uniqueness, some people might criticize that my judgment is not right in focusing on them, but there are some scandals still being noticed, so we should not forget about that fact either.

And in the twenty-first century, there has been a common reason globally of all the companies about the need to look into corporate governance. That is the question of the raison d’être of companies. As was mentioned earlier, the basic fundamental question is, you would see many scandals popping up one after another, society would question corporations as to the reasons of their existence, and corporations have to respond to these questions.

Another reason why corporate governance is required is that the companies need to make contributions for the sustainable development of the global society, so in the twenty-first century there is much more expectation on the part of companies from the society to be reliable. And in line with that, the corporate social responsibility is a new wave of the global society requesting companies to play a new role.

And furthermore, companies who are paying respect to governance and corporate social responsibility are receiving higher evaluation. So governance, corporate governance and CSR are used as yardsticks to evaluate a company. And in order to be rated higher, companies are now forced to be in compliance with corporate governance and perform good corporate social responsibility. So these are the reasons for the corporate governance to be focused.

If you look back on the situation starting from the 1990s up to now, first, corporate governance started to be discussed as a measure against corporate scandals, and then in the 1990s or towards the end of the nineties, many of the scandals have been settled, so now people started to discuss corporate governance from the point of view of corporate competitiveness. But once again there came another series of different corporate scandals of a different nature. So once again people started to discuss corporate governance and corporate scandal. That's the current status in Japan.

So that is point 1 of my talk, and moving on to point 2. I cannot go into details in the interests of time so I'd like to go through this very quickly. If you look at the reform of corporate governance in the 1990s there are four major aspects. One is the legal foundation for corporate governance. Commercial court and the securities exchange act in those days and antimonopoly law, these company laws served as an infrastructure in a major role as corporate governance. There were a series of amendments for that.

And secondly, in line with that, various organizations like Keidanren and the corporate employers association started to speak out about their own views on corporate governance reform. Not all of these proposals have been implemented but some are reflected in the amendments of laws. What is even more important for the corporate managers is that the companies themselves started to take their own initiative in reforming the corporate governance of the company. I will talk about this idea.

And then the Tokyo Stock Exchange finally at last started to get itself involved in corporate governance. I'm not being cynical when I say "at last." The NYSE and London Stock Exchange, they thought the TSE is now keeping the second transaction volume, but they are quite less enthusiastic about corporate governance-related matters.

But what serves as the core of corporate governance is the reform of the board of directors. Other speakers have already touched upon them, about the Japanese corporate board of management. In the past the characteristics and the features, as well as the issues of the Japanese board of management in the past is that there are too many directors and most of them are in-house members and the directors are all homogeneous in terms of their views.

And the second characteristic is that there is not a separation between the decision-making function and the executive function, as well as the supervisory function. So now there is a trend to separate them.

And the problems that come together is that at the board of directors it was difficult to make real decisions on policies and you do not have real substantive deliberation; it is just a venue of reports. And all the topics, items on the agenda are related to the different departments of the company and you are not talking about the corporation as a whole.

And even more problematic, was that it is a more fundamental issue that you used to have a pyramid-type of top-down system with a president at the very top in executing business. You have the president, vice-president, senior managing director, managing director and directors. In this hierarchy of directors there were issues and problems. The question is how we should reform them.

And it was, as you know, Sony who was first to voice out reform. Sony is now suffering from a variety of scandals and poor performance with the brands being damaged to a large extent. So as far as corporate governance is concerned, Sony has initiated a very significant initiative, and in June 1997 they went through a management structural reform. This is nothing new now, but this was the first undertaking to introduce the reform of the board of directors and introduce an executive officer system. The number of directors was reduced from 38 to ten, with three independent directors. The executive officer is a new position that they introduced. The total number of such executive officer was 27.

And in these systems, these reforms by Sony were a necessity because of its environment that surrounds the company. But many other Japanese companies followed suit to carry out reform introducing an independent director system which is a check on the representative director and introduced an executive director system, so that the board of directors is specialized in decision-making and supervisory functions and execution is a separate organization to be established, and the auditor system was further introduced with better internal auditing.

So the objectives of Sony's reform of the management mechanism were quite different from those other companies which simply followed what Sony did much later. This is from the webpage of Sony and here you can see the latest management mechanism of Sony. There are 14 directors on the board and ten of them are independent directors. The number of operating officers has now gone down to seven. Three operating officers are serving as directors of the board at the same time, so the share of the independent directors has risen and you can see the clear separation between the supervisory function and the executive function.

Some of you may be serving as corporate auditors, but the strengthening of the corporate auditor system has been implemented with the revision of the commercial code, especially for the so-called big companies or those who are regarded as big companies. These are the latest requirements applied to the big companies as a way to strengthen the corporate auditor system. And this is from the homepage of the Japan Corporate Auditors Association, and this is a traditional system or the system which keeps most of the traditional aspects of the Japanese management organization.

And now, moving on to what's happening recently, skipping about ten years of development, what's quite important is the revision to the commercial code, which took effect in April 2003. And big companies are given four different options for the managing and organization. First is the traditional type. And the second is traditional type with the operating officer system or executive officer system.

And the third is the one with a committee for disposing or taking over the important property, but this system was not popular. Honda has been the only listed company which took this system with the new company law which took effect in May this year. The one with a committee for disposing of the important property is abolished. Instead, a special director is now allowed to be appointed when there are more than six directors on the board and when one or more are independent directors. In those cases a special director can now be appointed. But despite this revision, this is one of the systems with the corporate auditor board system.

The fourth is the committee-based company. The old name was the company with the committee and others, but it's now created so that it's a committee-based board system. Sony is a good example, Hitachi, Nomura, Mitsubishi Electric. Those excellent companies have introduced this system. But the total number of those with a three-committee-based system is only 67 under 3,881 as of November 22, 2006. It's only 1.7 percent of listed companies using this committee-based method; the remaining 98.3 percent of the companies are still using the traditional type with a board of corporate auditors. I'm sorry I don't have time to go into detail about why.

And concerning the compliance, the initiative taken by the business circle was in

December in 1996 when Keidanren came up with the first revision to the charter of corporate behavior. They established it in 1991, but after that there are many cases of misdeeds and Keidanren thought that they would further revise the charter, so around 1996 the requirements of compliance had been strongly emphasized. And companies are required to have a guideline for compliance and then create an organization. When the organization guideline is available, a company is required to educate employees at every level, starting with the highest level of the top management, then to cover all employees so that there would be sort of compliance. This is how compliance should be ensured so that any warning sign for a misdeed can be caught or checked immediately. This is the basis for the internal control, although there are many difficulties in sharing the objectives of compliance.

Concerning compliance there are some important revisions to the law. First is the major revision to the securities and exchange law. The name of the law has been changed to the Financial Instruments and Exchange Law, and in June of this year some of the revisions have taken effect by the first statutory quarterly reporting.

And the second is the mandatory certification by management about the annual report. Today the management is required to certify what is described in their annual reports. But this requirement already took effect in January last year, not this year. So please correct this misunderstanding of mine; it was already implemented one year earlier. And there are bans on the false description of the annual reports and then on rumors and the accounting flaws. These are the new requirements added this June. And market manipulation is also banned today.

And with the new company law, big companies are required to establish and operate an internal control system. The companies feel that it’s quite costly if they have to follow the ideas of the financial service agency, but others say it’s not so costly. I have no way to say which is right. Some say the internal control is costly but others would say it’s not so expensive.

The internal control system, even before, hasn’t been required by law. Many companies already implemented that kind of internal control. When the internal control system has become a legal requirement, some adjustment would be necessary, but it’s not that the companies just recently started to establish internal control. There are many companies which already had an internal control system for long, although they are required to abide by the law strictly today.

Tokyo Stock Exchange as of March this year started to require the listed company to disclose information about corporate governance. Accountability and disclosure as part of governance is now required because it's a big concern to the investors in Japan and abroad. That's why we have so much attention on corporate governance and its disclosure.

And the last point I would like to discuss is the future perspectives of the corporate governance in Japan. Recently, well it really depends on the time span, but concerning the recent corporate governance discussion among Japanese businesses, I think I can summarize as follows.

Companies wish to speed up the decision-making; they want to separate supervision from execution and improve the efficiency of management and clarify the responsibility of the management. And second is that there is a need to improve the compliance and to strengthen risk management, and also to ensure the transparency of the management. So I think these are the two major thinking behind the companies in terms of corporate governance. The ultimate goal is to improve the true value of a company.

Market capitalization does not represent the true value of a company. If you ask what is the true value of a company, I would say that market capitalization may be the only way to talk about the value in a way that everyone can understand, but there may be more to that when we think about the true value of the business. So here we have a difficulty.

I talked about there are four options available for big companies, but I have to say that the system based on the board of corporate auditors would remain prevailing. Only 1.7 percent of the listed companies are operating under the committee-based board system.

And what's my view, my personal view on corporate governance? With that I would like to conclude.

I feel that the corporate governance, there should be no global standard for corporate governance because corporate governance is deeply rooted in the history, society, institutions, culture and customs of each country. It's institutionalized and it's deeply rooted in each society, so each country and society develops the most suitable corporate governance as a system. Therefore, there can be no global standard for corporate governance, a governance system. One country should not become the global standard or there should be no convergence into one national system. The European-wide governance system would not be created the Latin influence and the Anglo-American or the German background would mean that there would be several different kinds of governance systems. I don't believe in the emergence of one single European corporate governance system.

And I have to repeat again: corporate governance has no function either to suppress business misdeeds or to promote business competitiveness. Reform based on corporate governance, even though it's done successfully, would not eliminate company misdeeds completely or it would not ensure the strengthened competitiveness.

The management at the core of a business and their behaviors can be supervised and controlled by the governance system and it seems to be the common understanding by the business circle. Those outside of the company can ensure governance; those inside the company can ensure governance. These two are receiving a lot of attention, but we should not forget about the importance of self governance by managers or management themselves. I have to say that self-governance is the most important aspect. I don't hear others saying such an opinion, but this is my belief that it's quite important that the management themselves have self-governance instead of relying on internal-external governance in order to exert the true meaning of governance.

And today we face many cases of misdeeds. Some of them are quite surprising and they are shaking the foundation of Japanese corporate society. So the companies and management are required to answer the basic question of what is the reason of the existence of a business. So that's why people are so much worried about business ethics and the CSR, corporate social responsibility.

What's important is whether the business ethics and the sense of social responsibility held by the management is shared by all the employees or not. The issue is whether all the employees feel the same feeling with the top management or whether they have a good alignment in terms of the direction to be followed by the company. So a business should always develop a basic philosophy or principle about the management in a way to accommodate the changing environment, otherwise, the businesses would fail. So, the key to the success and survival for any company is the management, and the key for the successful management is whether that person has self-governance capability or not.

This is my flow chart for the self-governance by the management. Can I have ten more minutes? In the twenty-first century, businesses are required to make a contribution to the sustainable development of the global society as a global citizen, be it a company in Japan or in the EU. So companies in the EU and in Japan are required to become a socially trustworthy company in order to fulfill its contribution.

In order to become a socially trustworthy company, what do we have to do? Corporate governance-based reform or compliance-based management or CSR-based management would not ensure that a company would be a socially-trustworthy company. A company can be a socially-trustworthy company only when the governance, compliance, CSR and ethics are combined and operated identically in one package. So what's most important is the human resource development based on the excellent view on humanity with a strong sense of ethics.

What I said may sound very big and some of you might disagree, but with this I would like to conclude. Thank you very much for your kind attention.

**”EU Enlargement and Corporate Governance Reform in Eastern Europe”**

Dimiter S. Ialnazov, Assistant Professor, Graduate School of Economics,
Kyoto University

**Dimiter Ialnazov**: (in Japanese) I am Ialnazov from Kyoto University. I am from Bulgaria. As you know, in January next year Bulgaria and Romania will become members of EU. It’s been decided. In January next year there will be 27 member countries in the EU. In preparation for the accession, EU rules (the *acquis communautaire*) have to be introduced to the member candidates. Today in Bulgaria, the parliament is busy with passing all laws necessary for EU membership. By the end of this year alone, more than 130 laws will have to be passed by the parliament, otherwise we will not be able to satisfy the criteria of EU membership. There is a very strong pressure on the Bulgarian government from the EU to pass all those laws.

Most EU pressure has been toward particular areas such as the judicial reform, organized crime, and money laundering. But when it comes to the corporate governance area, the transplant of EU rules and their impact have not been discussed as intensively as the above-mentioned issues. However, I believe it’s quite important to study the corporate governance issues as well. As for the details of my paper, I would like to continue my talk in English.

My topic is EU enlargement and corporate governance in Eastern Europe. And the aim of my paper is to identify what is the impact of EU enlargement on corporate governance in former socialist states. As you know, two years ago, eight former socialist countries joined the European Union, and next January another two former socialist countries, Bulgaria and Romania, will join. The idea of this paper is to clarify how exactly the EU rules in this area of company law and corporate governance are transferred to Eastern Europe and what happens after that.

Here I use the theoretical framework of the Europeanization literature, which has been developed for the EU-15, the so-called old member states, but recently some researchers have expanded it to analyze the impact of the EU on former socialist states who joined the EU, or even some former socialist countries who will probably not join the EU, like Russia, but they still are very much influenced by developments in Europe in the area of corporate governance.

Europeanization is the impact of the EU on domestic policies and institutions in the member states or in the candidate countries. And the main research questions which I'm going to try to answer are: first of all, through what channels are the EU rules transferred to Eastern European countries? Second, when we are talking about EU rules in the area of corporate governance, what exactly are we talking about? And third, what happens after the transfer? So the rules are transferred, these are kind of foreign rules, foreign to the host country, and then how are these rules met by various institutions, various actors in the accepting country. By domestic actors I understand mainly the government and business associations, and companies.

In my paper I examine corporate governance developments in Eastern Europe by analyzing both the external pressures coming from the EU, as well as the domestic logic of corporate governance reform. And the domestic logic of reform can be explained by looking at what happened in these countries over the 1990s, after the fall of socialism.

One thing that happened was privatization. Most companies in these countries were formed through the privatization process in the 1990s. As you know, the socialist system was characterized by almost 100 percent of state ownership. So to build the market economy, all these countries had to undergo a process of privatization of their state-owned enterprises.

So in terms of domestic factors, which influenced corporate governance in Eastern Europe, I think the most important factors were the methods of privatization, and the strength of institutions. There were different methods of privatization in different countries. One of them was cash sales, or selling the state-owned enterprises for cash to outsiders. By outsiders I mean investors who come from outside the enterprise, for example, foreign direct investors. Another was the voucher privatization, which was about giving away for free the shares of the former state-owned enterprises to the whole adult population. Also, manager-employee buy-outs, which meant selling at preferential conditions the shares of the state-owned enterprises to a group of managers and employees.

Then about the strength of institutions. The transition to the market economy was a very difficult process in all countries of the region, but we can differentiate between two groups of countries according to the strength of institutions. For example, in terms of rule of law and security of property rights, the countries which managed to join the European Union two years ago had remarkable progress, especially I would like to mention Poland, Hungary and the Czech Republic, while many former countries of the Soviet Union and southeastern Europe, like Russia, Bulgaria, and Romania, had big problems in establishing such basic institutions of market economy like secure property rights or the rule of law.

With the risk of great simplification, I divide the countries into two groups according to the methods of privatization and the strength of institutions. Where the prevalent method of privatization was cash sales to foreign direct investors and the institutions were strong, there have been less corporate governance problems. The countries, which belong to this first group, are Poland, Hungary and Estonia. These are the countries where most foreign direct investment, went after the start of the transition and who managed to keep their institutions quite strong.

The second group of countries, or the “bad guys” so to speak, is where we’ve had lots of problems in corporate governance, was characterized by selling the state-owned enterprises to insiders (managers and employees) through voucher privatization or management-employee buyouts, and by very weak institutions. And here I put the Czech Republic, Russia, Bulgaria, Romania and some others.

In this second group we’ve had numerous corporate governance failures over the 1990s, which are very well known from an extensive literature. Let’s take as an example the phenomenon of “tunneling”. Tunneling is a new term that originated in the Czech Republic, which was the first country to implement the voucher privatization. Tunneling is a form of self-dealing, meaning that managers of this privatized state-owned enterprise transferred the cash or the assets of the enterprise to their own private companies, and the value of that enterprise declined because of their actions.

Another problem was the so-called “dilution”. The managers or the dominant owners, which appeared after the privatization, managed to increase their own stakes in the enterprises, thereby diluting, or reducing the stakes held by minority shareholders. And I have to say that when I’m talking about minority shareholders, I mean ordinary citizens who received for free their vouchers during the privatization, and who thought they had some ownership in these enterprises. In the end they found out they had nothing because the new owners/managers managed over time to use various methods to increase their own stakes.

A third way by which minority shareholders were hurt was de-listing from the stock exchange without tender offers. In many cases the new owners/managers, managed to stop the public trading of shares without paying any compensation to the minority shareholders, so one day ordinary citizens found themselves in a position where they could not sell the shares they got from the privatization.

When we talk about corporate governance in Eastern Europe, its first important feature is the ownership structure. All over the world we have two types: dispersed and concentrated ownership structures. In Eastern Europe the corporate governance system is characterized by a very concentrated ownership structure so it is close to the continental European model. East European companies are controlled by dominant shareholders, e.g. individuals or other companies who usually hold at least 30 percent of the capital. The dominant shareholders are usually former or present managers, other domestic investors or foreign direct investors.

The second feature is how investments of the privatized companies are financed. And here we see that financing by using own sources, like retained earnings or loans from companies of the same groups, is the prevailing feature of the corporate governance system in the Eastern part of Europe.

Another characteristic is that the corporate governance mechanisms that are well-known from the literature, for example the board of directors, the threat of hostile takeovers, and some others are not functioning because the board is completely dominated by the new majority owners which can decide almost everything they want to decide, and hostile takeovers are very difficult because of the high concentration of ownership.

So the corporate governance problem in Eastern Europe is different from that in the US or Japan. Usually in Japan by corporate governance, you mean how shareholders monitor and check the actions of managers. But in most of the literature about Eastern Europe, the main problem is the conflict between large and minority shareholders. And the evolution of corporate governance in Eastern Europe has been in the direction of stronger protection of minority shareholder rights.

Here we come to the issue of the impact of the EU. The EU is one of the external forces that push corporate governance reform in Eastern Europe. On the one hand, the EU has reinforced the tendency, which arose from the domestic logic of the reforms, towards stronger protection of minority shareholder rights.

On the other hand, we can witness a very interesting phenomenon, that after the fall of socialism, the rights of employees have been almost completely abolished. The role of the employees in the management of East European companies has become quite minimal. With European Union accession, as I've said, East European countries have to introduce European legislation, therefore they also have to introduce the so-called social model, part of which is about employee information and consultation rights.

There are several European directives about information and consultation rights. This is an example of external pressure for reform, which is contradictory to domestic developments. Business actors in Eastern Europe were unpleasantly surprised by the passage of laws giving employees information and consultation rights, but they cannot do anything because this is the requirement by the EU.

Here I come to the other research question in my paper about the main channels of EU rule transfer. How exactly, through what channels are the European rules transferred? One channel is the forceful, top-down imposition of EU rules, and this is the accession conditionality. All candidates have to transpose the *acquis communautaire* into their domestic legislation and this has to be done; there is no other question. The other channel is the voluntary adoption of rules, for example by companies or governments to achieve a better reputation.

And what exactly are the EU rules on corporate governance? I have several slides here. So first of all, most of the EU rules in this area are not unique to the EU. They are not developed by the EU itself, they are more of a mixture, a cocktail of various elements borrowed from company laws of the member states, from the US system, from the OECD corporate governance principles, etc.

There have been some attempts by the European Commission to harmonize company laws and corporate governance across the EU, but the general evaluation of these efforts is that the commission has failed to do this. The first reason is strong resistance by some member states who want to keep the diversity of national corporate governance models.

The second reason is uneven implementation. Even if some common rule is decided, the implementation is left to the member states, and here we can have some divergence in the implementation.

Also what is typical about EU rules in the area of corporate governance is that they set only some common minimum standards and everything above these standards is left to the discretion of member states. Abiding by certain key rules is either left optional or subject to non-binding recommendations. Prof. Kessler talked about the recommendation on non-executive directors. In this recommendation the commission says that member states should include in the company boards a sufficient number of non-executive directors. But exactly how many directors should be included on the board is an issue, which is left to the discretion of each member state.

Also in the takeover directive, passed in 2004, there are two key rules, e.g. board passivity rule, which is Article 9, and the breakthrough rule, which is Article 11. The implementation of these key rules is also left to the discretion of the member states. They are not obligatory.

The approach of the EU toward corporate governance is basically a soft approach, which relies on public consultations, non-binding recommendations, learning and persuasion. I think it's quite similar to the so-called open method of coordination, which was decided with the Lisbon Strategy, and has become one of the new interesting methods of governance in the EU.

The benefit of this approach is that it allows a lot of flexibility and respect for the diversity of the national corporate governance models in the old members. With regards to the new members, I can say that there is less flexibility, maybe because of this accession conditionality, or because of the eagerness of the new member states and candidate countries to become Europeanized. But, the chapters of the *acquis* on the freedom to provide services and on company law, have to be implemented in Eastern European countries and the implementation has been not so flexible. In many cases, the European directives or recommendations have just been translated before being passed as laws.

Let me give you some examples of the adoption of EU rules on the Bulgarian case. There is the large holdings directive, which says that voting right blocks in excess of 10 percent should be disclosed. This directive was transposed into Bulgarian legislation in 1995 with the adoption of the first securities law. And as I said a while ago, there are two directives about information and the consultation rights of employees from 1998 and 2002. These directives have been transposed recently through amendments to the labor code and before that through amendments of the commercial code.

Now a little bit about corporate governance failures in Bulgaria in the 1990s. As I wrote here, the problems came both from the laws themselves and the implementation of the laws. The main problems were tunneling, the dilution of minority investor stakes, and de-listing without tender offers.

And since 2002 there has been corporate governance reform, and here again we have this interaction of domestic and external forces pushing the reform. As for the domestic sources, there has been this new government which came to power in 2001, this is the National Movement Simeon II government, the government of the former Bulgarian king, and the economic team of this government was composed of young people who previously worked in the city of London as investment bankers or consultants. And these people when they came to power they really wanted to correct all the corporate governance problems which emerged during the 1990s and to improve the reputation of Bulgarian companies outside Bulgaria. So this was one domestic coalition, domestic force, which pushed for reforms.

And then the external reforms were, as I've said, the accession conditionality, which started with the accession negotiations with the EU. And second, the work of USAD consultants. They had a program about corporate governance in Eastern Europe and these many ideas or parts of the American model entered company law, securities law through the work of USAD consultants.

And the consequences of the reform, like we have recently much stricter legal rules after all these amendments which I mentioned regarding information disclosure by companies or protection of minority shareholder rights, and finally some improvement in the enforcement capacity of the government. So the government regulator, which is called the Financial Supervision Commission, has finally become more active in trying to find out companies which violate minority rights, which do not disclose the necessary information, and the commission can now impose quite severe sanctions, penalties, on such companies.

So in this area there has been some improvement because of that, but also the reaction of the managers or owners of many companies has been against these strict new rules. And I have done some surveys of company manager, which show their reactions to the new rules. So here I've identified five types of companies or five types of reactions, adaptation strategies. The first one is the exit strategy, which is just delisting from the stock exchange to avoid the new regulations. And the main reasons which the managers, when I talk to the managers why they delist, they say this new stricter legislation obliges us to consult all the time with the general meeting of shareholders and this leads to very slow decision-making. We need faster decision-making, that's why we want to avoid these strict rules and delist from the stock exchange, which allow them more flexibility and more speed in decision-making.

Then in the listed companies, on the Bulgarian market there are many small companies, and for small companies it's very costly to prepare all documents which are required by the Prospectus Directive of the European Union. There are so many documents and the small companies cannot afford, therefore they also want to delist to exit, avoid these regulations.

The second strategy is complete disregard, just ignoring the laws and regulations of the government.

The third one is formal compliance, which is formally complying with all the regulations, but in reality they submit some reports, some statements, even a corporate governance statement. But when you see the contents of this corporate governance statement it is really poor; it does not give any substance. And it's just a formal way of saying that we comply with the requirements.

Then there are two quite interesting strategies. One is voice, which is a strategy undertaken by the business community to adapt the strict European rules to the Bulgarian context. And this is a relatively new strategy because until now the business has been very passive in most cases, just submitting passively to the top-down imposition of rules or trying behind doors to influence the government and decision-making. But in this case they started openly discussing problems in the implementation of the European rules, and one example is the proposal of this industrial association—it's called the Association of Industrial Capital—which proposed to allow the delisting of small illiquid companies from the stock exchange without tender offers, which is in violation of European Union rules, but they wanted to allow it because it is more matching Bulgarian conditions. And in the end there was some compromise with the government; these companies remained listed but they were moved to a special segment with much laxer corporate governance rules, so they don't have to follow all the official rules for information disclosure and minority shareholder protection.

And the last strategy I want to talk about is acceptance, which is still quite a few companies but it's adoption of the EU rules, like voluntary adoption of the EU rules. At their own free will companies adopt these rules because they think that by doing that they will increase their reputation. And I've found several types of companies who have chosen this acceptance strategy.

And what is the role of EU accession? It is exactly the change of expectations of the managers. With the prospect of joining the EU they feel that there will be even stronger, harsher competition in the enlarged EU market; that's why they need to prepared for that and they will need some more investment financing. So they need to improve their corporate governance, their image in front of international investors, to receive such investment and to prepare better for competition on the EU market.

The next role of EU accession has been that investor expectations of the countries joining the EU have led to higher share prices. For a long time the share prices of Bulgarian companies has been very low, like under-valued, but when EU accession has been decided then suddenly they realized that prices are going to increase in the future and they started buying shares of the listed companies. So the market has already reached some stage of maturity where company owners and managers realize that improving corporate governance can be in their own interests leading to higher share prices.

And finally I found this luck of fortunate circumstances of having young open-minded people with international experience in the management.

And in conclusion, I found that EU enlargement has reinforced, has strengthened the trend which already existed coming from the domestic logic of reforms in Eastern Europe, so that's improving information disclosure and minority investor protection on the one hand. On the other hand, it has created a new trend towards including the employees in the governance of companies through the European directives on information and consultation rights. And I also examined the domestic actor responses, especially company manager responses to these new rules which are very varied.

The main problems which still remain are that in most cases these EU rules do not fit very well the domestic context in many Eastern European countries. They have been developed for mature market economies, but Eastern European countries are young, emerging market economies. In many cases these rules are too complicated for these countries, and therefore the enforcement of EU rules has not been very good, so another problem is the weak enforcement of the rules by the government and the courts. Thank you very much.