

# Corporate Governance Principles

--A Japanese View--

(Interim Report)

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Corporate Governance Committee

Corporate Governance Forum of Japan

## **The viewpoint of these principles**

The principles listed herein are designed as a two-step formula for realizing effective corporate governance:

- Principles that should be adopted in approximately five years, along with legal reforms, are “Step A Principles”, and are indicated below as [Principle A].
- “Step B Principles” are those which should be aimed for in the early 21<sup>st</sup> Century, are necessary (with amendments) to illuminate the path toward the globalized market, and which require legal reforms on a grand scale. They are indicated below as [Principle B].

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## 1. Introduction

1-1 The globalization of the marketplace has ushered in an era in which the quality of corporate governance is a crucial component of corporate survival. The compatibility of corporate governance practices with global standards has also become an important part of corporate success. The practice of good corporate governance has therefore become a necessary prerequisite for any corporation to manage effectively in the globalized market.

1-2 The publicly-owned corporation, a basic component of corporate society, is actually a system of cooperative relationships between various stakeholders, including shareholders, employees, clients, suppliers, creditors, and management. But shareholders in particular are given a special position. As owners of the company, they are the last risk-takers who are entitled to claim the residual profits of the company. Under the system of private ownership, shareholders are granted the right of governance over the company for the benefit of their own interests. This idea forms the foundation for the corporate governance concept.

In publicly-owned corporations, the board of directors is the most effective vehicle of corporate governance. The current system adopts corporate governance practices only when demanded by the shareholders. The shareholders -- who may be geographically scattered -- may elect directors, who in turn choose executives to effectively manage the company on behalf of the shareholders. Therefore, the executives must be responsible for pursuing the shareholders' profit with the most prudential fiduciary duty. Moreover, management executives, as the shareholders' trustees, must be fully accountable to the shareholders for their actions.

1-3 From the Japanese perspective, corporate governance by definition rests with the conduct of the board of directors, who are chosen on behalf of the shareholders. The directors are entitled to govern the company, and to supervise and monitor the company's management in order to promote effective management and ensure prudent accountability to the shareholders. The board of directors therefore is the primary overseer in the company, monitoring management to ensure that it is a) always endeavoring to maximize corporate value in the long term for the shareholders, and b) always prepared to be accountable for its actions to all the stakeholders and -- in particular -- to the shareholders.

It is a fact, however, that in practice the role of the board of directors and that of the management executives has not always been defined. Furthermore, the board of directors has not necessarily been equipped with sufficient governance authority and capabilities. The corporate governance principle described herewith proposes that the governance powers of the board of directors be firmly established, thereby guaranteeing both the effective management and prudent accountability the company needs to survive in the globalized marketplace.

1-4 It goes without saying that the workability of the above-mentioned corporate governance system depends on the nearly flawless functioning of the market economy. Profit-seeking conduct by shareholders means that they expect to maximize residual profits after other stakeholders have already been given a fair share of the profits, according to the market mechanism. In other words, the role of management is to strive to maximize shareholders' profit, while simultaneously coordinating the appropriate profit level for other stakeholders in the market. As long as the market mechanism is properly functioning, management's effort to maximize the shareholders' interests is justified.

In reality, however, the market mechanism does not function perfectly due to market failure and to administrative regulations. This is why management's oversight of the allocation of profits among stakeholders is indispensable. Such oversight is accomplished through management's efforts toward positive disclosures of their coordination of profits to stakeholders as well as to the corporation's constituencies. Moreover, this is why the board of directors' governance takes on even a social responsibility: through their duty of supervising management's actions, the directors are contributing toward the transparency of the market. Otherwise, in a skewed market, the directors cannot coordinate the relative interests of stakeholders in an appropriate way.

1-5 It may be useful to provide a brief description of the unique features of the Japanese *shacho* (president), in the context of the *shacho's* style of corporate governance. The Japanese *shacho* is the CEO, and often the chairperson of the board of directors. As the leader of his or her company, an effective *shacho* is hard working, spirited, reliable, level-headed, has good communication skills and a comprehensive grasp of the where the company is headed in the future. All these qualities, however, are insufficient unless he or she is a person of responsibility, firmly determined to maximize long-term corporate value. Modern corporations should be on-going concerns. Thus, their corporate value – which should be the equivalent of the shareholders' value – is expected to be maintained over the long term. The legitimacy of the *shacho* is really derived from and recognized

only by his or her sense dedication to be fully responsible to the shareholders, whose desire is the maximization of shareholder value.

1-6 Without duly stable cooperation between employees and management, shareholders' value as such will never be maximized. To achieve smoother and more effective cooperation, Japanese companies have introduced such uniquely Japanese devices as the "bonus system" and "stock-holding plans", which basically share profits with employees. Recently, stock option plans have also been adopted, though their use is preliminary. The goal of these systems is to achieve compatibility between maximizing shareholders profits, and maximizing the profit "pie" for all stakeholders.

1f The "principles" presented below have been written to present a Japanese model of corporate governance. They place special emphasis on the importance of the shareholders, and on the board of directors, who function simultaneously as the shareholders' delegates and as the promoters of the benefits of all concerned stakeholders.

## **The Japanese Corporate Governance System: Problems to be Solved**

- 2-1 The European (Continental)/Japanese model vs. the Anglo-American model:
- the concept of the company as a community vs. the concept of the company owned and governed by shareholders, who are the last risk takers
- 2-2 The globalized market: A competitive arena for two systems
- the Euro-Japanese vs. Anglo-American model
  - system of seeking profits for “pluralistic-oriented” constituencies vs. system of seeking profits for “individualistic-oriented” shareholders
- 2-3 The Japanese model does not allow hasty labor restructuring. This model should be preserved. Economic ineffectiveness should be corrected not by terminating employees, but instead by redeploying them in the wider interests of society.
- 2-4 Labor adjustment can represent an easy transfer of business risks to employees, a practice that violates the basic ethics of capitalism and the Japanese notion of corporate governance.
- 2-5 The Japanese method of quality control in manufacturing has created a high-grade “zero defects” system in which product faults are to be detected along the flow of the production line and should not be carried over to the final inspection process. Why not apply this concept to corporate governance? It implies continuous and processional detection by the board of directors, a process that would be much better than current auditing system.
- 2-6 The conventional Japanese corporate governance model consists of a dual structure: the board of directors, which carries out the functions of strategic decision-making; and the board of auditors, which audits management’s execution of business activities.

The latter does only *ex post facto* auditing, and tends to be remote from the decision-making process.

The former does not have real decision-making power. Instead, decisions tend to be actually taken by the “management board”, or by the “management board of directors”.

Indeed, most members of the board of directors are “executive” directors (inside the company) and therefore are often “employees” of the company. In this situation, the realization of meaningful governance is difficult.

2-7 The function of the board of directors should be rejuvenated to i) cope with the more complicated global market; and ii) to be honest advisors for management, which could be trapped with a dilemma whereby stronger managers could become more complacent.

### **3. Accountability and Disclosure**

3-1 Corporate management is to be fully accountable to explain to the shareholders how much profit is generated out of their assets that are under the fiduciary care of shareholders. This is basically an “offer of information” within a closed loop of immediate directors and shareholders.

3-2 On the other hand, offering information to outside parties, or “constituencies” may be called “information disclosure”.

3-3 Though they differ in nature, in practice these two types of information are usually treated as identical. This is because among widely scattered shareholders it is difficult to maintain confidentiality. In practice, therefore, the realm of confidentiality extends beyond the closed circuit of immediate stakeholders, reaching out to relatively remote constituencies.

3-4 But, the fundamental difference between the two types of information certainly exists. Therefore the “information offer to the shareholders” and, and a general “information disclosure to the stakeholders” should be recognized as two different concepts.

[Principle 1A] The board of directors should be fully equipped with comprehensive information systems within the company so as to provide correct and substantive information to the shareholders. Furthermore, other important information derived from outside the company’s system should also be centralized through the company’s entire information network.

[Principle 2A] Information offers to shareholders should be made not only by means of formal business reports, but also by quick disclosure whenever necessary, particularly in the case of very important incidents which might affect the shareholders’ interests.

[Principle 3A] The board of directors should always be alert to upgrade the quality of information to the shareholders. Consolidated statements, semi-annual settlement of accounts, etc. should be swiftly adjusted to new global accounting rules.



The upgrading of investors' relations organization is also to be introduced, and, possibly, a quarterly settlement of accounts is to be introduced.

[Principle 4A] The board of directors bears an important responsibility to coordinate the various interests of all the other stakeholders, while simultaneously representing the immediate interests of the shareholders. Therefore, the directors should undertake wider disclosure of company information for the benefit of non-shareholder stakeholders.

## 4. Governance Structure

### 4-1 Directors and the Board of Directors

[Principle 5A] The board of directors should include independent, nonexecutive directors who have no direct interests in the company.

[Principle 6A] The number of directors is to be appropriate in the sense that it should guarantee effective discussions to draw articulate and swift corporate decisions.

[Principle 7A] The functions of the board of directors and any executive board should be separated so that corporate decision-making and business execution are clearly distinguished.

[Principle 8B] Independent, non-executive directors should comprise a majority on the board.

[Principle 9B] Within the board of directors, several committees should be established, such as those for designating directors, setting directors' remuneration, business auditing, etc. Non-executive directors are to make up the majority on these committees. Remuneration of the *shacho* and other "representative" directors is to be decided only by non-executive directors.

[Principle 10B] The chairperson of the board of directors – as the highest responsible member of the governance structure – and the chairperson of the board of executives – as the highest responsible officer of business execution – are not to be the same person. When the combination of the two functions is necessary, an explanation should be offered to the shareholders.

[Principle 11A] A Management Advisory Board may be created as an alternative body in place of Principle 5A.

## **4-2 Auditors and the Board of Auditors**

[Principle 12A] The quality of corporate auditing has to be upgraded by designating more than one independent auditors, and by a more systematized auditing. The “five year rule”, by which a virtually inside officer could be designated as an auditor after five years of absence from the company or related company, must be abolished.

[Principle 13A] Auditors should audit beyond the normal inspection of compliance by management, and at the very least should make due judgments on the strategic decisions made by the board of directors.

[Principle 14B] An auditing committee is to be created within the board of directors. All the members of the committee are to be non-executive directors. Its function will be to audit the quality of compliance achievements, as well as the appropriateness of risk management of management.

## **4-3 Shareholders' Meetings**

[Principle 15A] Shareholders' meetings should be utilized to enhance the dialogue between the shareholders and the board of directors. This is desirable to promote the quality of directors' accountability.

[Principle 16A] Separately from the shareholders' meeting, information meetings for major shareholders may be held for more detailed discussions.

[Principle 17B] Items decided in the shareholders meetings are to be limited to those of vital importance to the business management.

## Corporate Governance Committee Members

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### **Vice-chairperson**

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