

# JAPAN ECONOMIC CURRENTS

A COMMENTARY ON ECONOMIC AND BUSINESS TRENDS

## Corporate Governance in Japan

by Yoshio Nakamura, Senior Managing Director, Keidanren

### What can Japan Learn from the United States?

Corporate governance became a topic of serious debate in Japan about 10 years ago under the Structural Impediment Initiative (SII) consultations between Japan and the U.S. during the previous Bush Administration. In the context of the SII talks, which were aimed at resolving structural problems, the U.S. urged Japan to review its corporate laws.

Specific reforms advocated by the U.S. included: making it easier for shareholders to file derivative lawsuits by cutting administrative fees; making it possible for a group of litigants to file class action lawsuits; increasing shareholders' access to

balance sheets; stiffening penalties on companies that refuse their shareholders reasonable access to accounting records; ensuring a mandatory guarantee of the cumulative voting system, and establishing a system of outside directors and audit committees. The basic thrust of the U.S. argument was that Japanese companies were not sufficiently subject to shareholder control. This laxness allegedly gave a competitive edge to Japan and caused distortions in the international balance of payments.

What a difference ten years make. In the early 1990s, the U.S. seemed to argue that "Japanese firms are too strong because they do not follow American management practices." Even as late as the 1997 Asian financial crisis, the U.S. believed the family-run management style of Asian corporations was a root cause of economic woes and urged (through the World Bank and the International Monetary Fund) the adoption of American-style corporate governance in which management is "subject to checks by outside directors so that shareholders' interests are respected." Today, thinking in the U.S. has changed to, "Asian firms are weak because

they do not follow American management practices."

These shifting U.S. arguments prove that the particular form of corporate governance—regardless of whether a company has outside directors or statutory auditors—does not have a direct bearing on a company's performance.

I am skeptical about claims that American companies respect shareholders' rights and interests substantially more than Japanese firms do. The Keidanren tested this assumption by attending some Annual General Meetings of shareholders in the U.S. and interviewing executives responsible for investor and shareholder relations. It quickly became clear that American companies do not necessarily give priority treatment to shareholders. For example, the performance of U.S. corporations deteriorated nationwide in 1992, but directors' remuneration in large corporations remained high.

Frustrated that checks by outside directors and others had proved ineffective in trimming excessive salaries for top management, Congress became interested in this matter, and eventually the Securities and Exchange Commission (SEC)

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changed its regulations to require companies to disclose the salary histories of their CEO and senior executives to shareholders.

In 1993 the CEOs of well-known companies were dismissed by outside directors because of their companies' deteriorating performances. But the reason the outside directors exercised their power in these cases was because under Employee Retirement Income Security Act (ERISA), to seek to maximize their interests as shareholders on behalf of pension-fund

“Changes in the Japanese shareholder structure are bringing about corresponding change in corporate governance.”

members. The function of outside directors in the U.S. was strengthened when Congress passed the Foreign Corrupt Practices Act of 1977. But it was a full 20 years before the outside director system mandated by U.S. law actually functioned.

If there is something to be learned about corporate governance from these experiences in the U.S., it is not that Japan should blindly introduce an American-style system that is centered on outside directors. Rather, Japan should establish a system of management

that respects the signals emanating from institutional investors and other players in the capital markets.

As a result of the reforms in Japanese capital markets, managers are attaching greater weight to market trends. To succeed, Japanese corporations must abandon old management practices and change corporate behavior.

### 2. Japan's changing capital markets

In response to evolving international competition among capital markets, the government implemented a “Big Bang” major liberal-

ization of Japanese capital markets in 1997. These capital market reforms, so far on schedule, should be completed in 2001. Other reforms include the abolition of a requirement that stock exchange members deal on only one exchange, the liberalization of commissions, an amendment of the Securities and Exchange Law, and a review of the securities tax system. A major reform of accounting standards is also under way.

Indeed Japan is introducing, ahead of other countries, compulsory market value accounting for financial instruments this fiscal

year. Considering the European Union is weighing taking this step in 2005, Japan's action is very bold and is a reflection of the importance of the market.

Reform of capital markets, in combination with the reorganization of financial institutions and the introduction of market value accounting for financial instruments is certain to change Japan's shareholder structure. One such change is the unwinding of cross-shareholdings. According to a survey conducted by a Japanese insurance research firm, 20.30 percent of all shares outstanding were cross-held in 1989. But by 1999, it had dropped to 10.87 percent. The proportion of shareholders who are financial institutions has declined, while the proportion of foreign shareholders has grown. According to reports, foreign investors now hold some 20 percent of all shares outstanding of Japanese listed companies. The ratio of private shareholders has also been increasing steadily, although it is not yet as high as during the period of the bubble economy.

Changes in the Japanese shareholder structure are bringing about corresponding change in corporate governance. Due to the reorganization of financial institutions, non-financial corporations

are shifting their priority from indirect to direct financing. As a consequence, a growing number of companies are adopting a philosophy more oriented toward shareholders. For example, general meetings of shareholders are managed very differently, and an effort is made to avoid a situation where many companies hold their Annual General Meeting on the same day. Attention is paid to dialogue with ordinary shareholders, and investors' relations are being increased attention by more and more companies. An association aimed at enhancing investor relations is amazed by the sudden spurt in the number of firms joining them. On top of this, companies are voluntarily increasingly taking the initiative in slimming down their boards of directors, and introducing outside directors and executive officers, in response to views expressed by their American shareholders.

In Japan, too, the age has arrived when corporate decision making and behavior must adapt in response to companies' assessment by ruthless capital markets.

### 3. Regulation and revision of the Commercial Code

In spite of changes in capital markets and the reforms being undertaken by companies on their

own initiative, Japan's Commercial Code, which regulates domestic corporate activity, continues to have a strongly mandatory character. Because this Code has not kept pace with global economic conditions, Japanese corporations cannot compete on an equal footing in international markets.

Due to the increasing number of foreign and individual shareholders, for example, it is becoming much harder to achieve a quorum of shareholders in a general meeting—even in situations requiring swift action, such as reorganizations of companies, mergers, or corporate breakups. In Britain the quorum is two shareholders. The U.S. state of Delaware allows a company's articles of incorporation to define the quorum as one-third of the shares with voting rights. In

freely in the articles of incorporation, but a majority of voting rights is needed to make up a quorum for special resolutions, which are needed to approve reorganizations of companies—a situation that causes practical problems for companies. For this reason, the proposed revisions of the Commercial Code include a provision to lower the quorum requirement for special resolutions to one-third of the total number of shares outstanding.

As a result of progress in administrative and fiscal reforms and deregulation, Japan's society is changing from a regulatory pattern requiring prior consent for action to one of ex post facto checks. In the sweeping revision currently underway, a review is being considered of the mandatory aspect of the Commercial Code. Oddly, even in

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France, if the quorum is not achieved at a general meeting of shareholders, it can be lowered or abolished altogether for a second general meeting. In Germany, a quorum is not required.

In Japan, too, the quorum for an ordinary resolution can be defined

the midst of these reforms, calls for a strengthening of regulation from various quarters, including the U.S. government, are becoming increasingly strident. Over the past 10 years, commercial law worldwide has been substantially deregulated,

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while in the United States, commercial law has never had a markedly mandatory character. The trend is for countries to recognize freedom of corporate activity and try to foster companies that will survive in ever-fiercer international competition.

In the midst of this, Japan alone has been left behind. The Japanese Diet only recently passed legislation that would allow stock-for-stock swaps and corporate breakups essential for corporate reorganization. Provisions for corporate breakups only came into force on April 1 this year. Both of these procedures are in place in all industrialized countries, and a major revision of the Japanese Commercial Code is a logical conclusion.

The Legislative Council of the Japanese Ministry of Justice recently sought public comments on an interim proposal for revising the newly drafted Commercial Code. The proposal contained wide-ranging and bold reform measures relating to the corporate share system, corporate organization, accounting, and disclosure.

As currently drafted, the proposal generally reflects the views of Japanese business. But there are two provisions opposed by the Keidanren: (1) the mandatory appointment of an outside director by "large-scale companies" (as

defined by the Commercial Code), and (2) the requirement of a shareholders' resolution in general meeting when companies owned shares of its important subsidiary companies are totally transfer to others. If the reform is truly intended to strengthen corporate competitiveness, there is no need for compulsory measures.

#### 4. Respect for corporate autonomy

I find it extremely hard to understand why the U.S. government in its comments on the interim proposal endorsed the mandatory appointment of outside directors. Keidanren is not opposed to the system of outside directors as such—only to the idea that their appointment be mandatory.

Firstly, of the 10,000 large-scale companies, 6,500 are corporations in which stocks are not publicly traded, and the imposition of such a

urged Japan to restrict this requirement to public companies.

Secondly, there is no reason to believe that outside directors will perform the checking function particularly well, as American-affiliated law firms and consultancies in Japan argue. As mentioned earlier, even in the U.S., it was only with the backing of institutional investors that outside directors were able to dismiss CEOs. Obviously, this is not always possible.

To sum up, mandatory appointment of outside directors is neither practical nor always effective. Decisions on whether to appoint an outside director would be best left to the companies themselves. ■

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Yoshio Nakamura, is Senior Managing Director, Keidanren.

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system on them would be unreasonable. This is clear without referring to the example of the United States, where stock-exchange listing rules call for outside directors. Not surprisingly, the U.S. government has

# “Koizumi Will Be Tested In Delivering Campaign Promises”

by Barbara P. Wanner

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Prime Minister Junichiro Koizumi, who enjoys near-rock star popularity in Japan, has given the Liberal Democratic Party (LDP) and its governing partners, New Komeito and the New Conservative Party (NCP), a new lease on life. LDP-backed candidates swept the July 29 elections for the Diet upper house, winning 65 of the 121 contested seats. This outcome contrasted sharply with the ruling party's devastating 17-seat loss in the 1998 upper house contests. As a result of these gains, the three ruling parties, at 139-strong, now hold a comfortable majority in the 247-member House of Councillors (see Table) in addition to controlling the more powerful House of Representatives.

With Mr. Koizumi's approval ratings in the 70 to 80 percent range, most politicians were not surprised by the LDP's stunning performance in the upper house contests. The Japanese leader, a self-proclaimed maverick, had proved adept at tapping into the public's desire for change and their frustration with the LDP old guard's closed-door leadership style and failed management of the economy. Mr. Koizumi issued a call for structural reform that resonated with the man on the street.

The media hyped the July 29 election outcome as a voter mandate for reform, and suggested that Japanese politics are entering a dynamic new era. The upper house polls certainly confirmed that Mr. Koizumi had developed a formidable public power base. But it still is unclear exactly what these elections mean within the context of Japan's still-fluid political scene.

## What Do The Votes Really Mean?

Voter behavior is hard to interpret. Turnout for the July 29 elections was only 56 percent as

compared to nearly 59 percent for the 1998 polls. This figure seemed low in view of reports of “Koizumi fever” sweeping the nation. One reason why more voters stayed at home this year may be precisely because of the hype. “The LDP's victory is a foregone conclusion, so my vote won't make much of a difference,” some Japanese may have reasoned.

But this election also posed unusual tactical questions that may have discouraged some Japanese

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## RESULTS OF JULY 29, 2001 UPPER HOUSE ELECTIONS

	Seats Won	Uncontested Seats	Upper House Total
<b>Ruling Parties</b>			
Liberal Democratic Party	65	46	111
New Komeito	13	10	23
New Conservative Party	1	4	5
<b>Opposition Parties</b>			
Democratic Party of Japan	26	34	60
Liberal Party	6	2	8
Social Democratic Party of Japan	3	5	8
Japan Communist Party	5	15	20
Independents/Minor Parties	2	10	12
<b>TOTAL</b>	121	126	247

SOURCE: “LDP HAS BIGGEST WIN SINCE '92 POLL,” *THE JAPAN TIMES*, JULY 30, 2001, PAGE 1.

## “Koizumi Will Be Tested In Delivering Campaign Promises”

“...[This] election posed unusual tactical questions that may have discouraged some Japanese from participating.”

from participating. Some voters may have been very attracted to Mr. Koizumi and his reform agenda but did not cast ballots for fear that a vote for a LDP candidate ultimately would strengthen the hand of the anti-reform old guard.

Further complicating post-electoral analysis, one exit survey showed that the proportion of non-aligned voters who backed LDP candidates was up threefold from the 1998 elections. On its face, this is a positive development. Nonaligned voters feel no allegiance to any organized party, and in the past have tended to cast protest votes that invariably hurt the LDP.

Given this pattern, the increased support of nonaligned voters for LDP candidates in the July upper house contests more likely reflected their endorsement of Mr. Koizumi and his rock-the-boat approach to governing and not necessarily their embrace of the LDP as a party. Basically, this portion of the electorate cannot be counted on to provide solid, ongoing support for the Japanese leader and his party. Thus, votes from the

nonaligned bloc also are not a reliable indicator of the depth of Mr. Koizumi's support or of a fundamental political transformation.

### **Making Good On Campaign Promises**

During the upper house campaign, the prime minister refused to divulge the specifics of his reform plan. This tactic was aimed at appeasing the conservative camp in order to maintain a united LDP front in the run up to the upper house elections. Once victory was assured, Mr. Koizumi quickly unveiled a three-stage plan to implement structural reform. This ambitious effort will focus on privatizing Japan's postal savings systems and 70-odd public corporations, addressing Japanese bank's crippling bad-loan problem, deregulating industry, reducing the country's massive national debt, and fortifying the social safety net.

Details of the first phase will emerge as the cabinet debates the guidelines for the FY2002 budget,

which must be approved by August 10. The budget debate will test whether Mr. Koizumi has the political will to make good on his vow to pursue “structural reform with no sacred cows.” It will also reveal whether he has a well-conceived plan or is simply a mouthpiece for populist rhetoric.

### **Political Repercussions**

More significantly, deliberations on the FY2002 budget could have an explosive political impact. Former Prime Minister Hashimoto and other old guard doyens critical of Mr. Koizumi's sweeping changes are expected to weigh in heavily to protect the “sacred cows”—the industries and interest groups that form the backbone of the LDP's conservative support base. And Mr. Hashimoto, who leads the largest LDP faction and haven for anti-reformers, possesses sufficient political muscle to dilute or even derail many of Mr. Koizumi's proposed initiatives.

“[D]eliberations on the FY2002 budget could have an explosive political impact.”

High on Mr. Hashimoto's to-kill list probably is the Koizumi administration's plan to reduce public

works spending by 10 percent. This cut would hurt the construction sector, a longtime supporter of mainstream LDP politicians. Mr. Hashimoto then may go after the prime minister's pet interest in privatizing the postal savings system (postal directors backed many of the LDP's upper house candidates) as well as try to scale back a proposed ¥1 trillion cut in subsidies to public corporations.

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Mr. Koizumi warned during the campaign that he would break up the LDP if old-guard conservatives refused to back his reforms. Presumably, the Japanese leader would form a new party, which would challenge the anti-reformers in lower house elections. This move, in turn, might precipitate a broader political realignment that would bring moderate members of the political opposition into Mr. Koizumi's new reform camp.

Mr. Hashimoto, indeed, may call the Japanese leader's bluff—particularly if the economic situation continues to deteriorate and public support for Mr. Koizumi begins to wane as Japanese develop less

stomach for the pain of restructuring. Under this scenario, the electorate may contradict themselves by returning the LDP old guard to power, motivated more by nostalgia than a renewed faith in their leadership.

Alternatively, Mr. Koizumi may feel that he has no choice but to meet some of the mainstream group's demands if he is to avoid total governing paralysis. This strategy probably would keep the LDP

intact, but runs the risk of driving reform-minded voters into the arms of the political opposition. The Democratic Party of Japan (DPJ), the largest opposition party whose *raison d'être* is reform, undoubtedly will monitor the debate carefully and attempt to embarrass Mr. Koizumi if he falls short of achieving promised changes.

## Outlook

Notwithstanding these political challenges, the charismatic Japanese leader potentially has staying power. Unlike opposition party politicians who voters tend to regard as inexperienced at governing, Mr. Koizumi enjoys the legitimacy of having spent 30 years in the party that has ruled Japan for most of the postwar period. He also appears to be scandal-free—in contrast to Morihiro Hosokawa, an earlier reformist premier who lasted only eight months. Mr. Koizumi's longevity in office and the outlook for meaningful political and economic change will depend on how skillfully he can enact his reform agenda, keep his party together, and maintain his public power base as the inevitable pain of restructuring sets in. Accomplishing these goals will not be easy, but the maverick leader may possess the savvy to pull it off. ■

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## Japan Business Dialogue

*KKC's monthly program featuring Japanese experts on the economy.*

### **"IT Transforming Society In Japan: A Corporate Perspective"**

*Andy Kikuchi, speaker,  
Matsushita Electric Industrial  
Company, June 27, 2001*

Japan's IT strategy is three years behind the U.S., said Andy Kikuchi, Director of Matsushita's Washington office. To catch up and "hopefully surpass" the rest of the world, he explained, the Japanese government introduced an ambitious "e-Japan Project" in July 2000 aimed at:

- Wiring a high-speed, always-accessible network for 30 million households (70 percent of Japan's population) and an "ultra" high-speed network for 10 million households by 2003;
- Improving e-education;
- Expanding e-commerce;
- Establishing e-government and e-public works services; and
- Protecting computer networks from cyber-terrorists.

In 2000, with 37 percent of its households having Internet access (through PCs and mobile telephones), Japan ranked 14th in the world of high-speed Internet subscribers (Sweden is first, followed by the U.S., then Norway and Iceland).

Twelve percent of Japanese households also have access to

four broadband services (ISDN, Cable TV, DSL, and an optical fiber network), which provide a wide range of telecom, transportation, and electric power services.

About half of the Japanese population (66.8 million people) uses mobile phone service. NTT's DoCoMo i-mode service already has 18 million subscribers, for example. The promise of the next generation "3-G" of mobile phone service will increase data speed to 348 Kbps and provide global roaming, which will undoubtedly increase usage.

Digital television too has a strong consumer base in Japan. Sky Perfect TV, which just started service in 2000, has 2.7 million subscribers. Terrestrial Digital Television (scheduled to start service to metropolitan areas in 2003) will provide Internet access, four formats, high-quality picture, and far more channels than are offered today. By 2011, Kikuchi said, all standard televisions in Japan will be replaced by Digital TVs.

Japanese electronics companies, with Matsushita in the forefront, Kikuchi said, are gearing up to meet the demands of the Internet era with regard to new developments in e-living, e-service and e-mobiling. These improvements will

change the way Japanese work and live in the near future. ■

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Keizai Koho Center (KKC) is an independent, non-profit organization designed to promote the understanding of Japan's economy and society at home and abroad. Its financial resources are derived entirely from the private sector.

KKC fosters a deeper understanding of Japan's basic social structure. Furthermore, it conducts public affairs activities to improve the Japanese people's recognition of Japan's global role.

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