Some Preliminary Thoughts About Corporate Governance in Japan
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1. What is Corporate Governance

World capital markets are increasingly insisting that good "governance" is essential if corporations wish capital on the most competitive terms. By governance, what is meant is - - Transparency - the public disclosure of material information about a company sufficient to permit informed investment decisions. A recent egregious failure of transparency is the disappointing evidence that companies have not been forthcoming about the losses arising out of trading in derivatives; and

- Accountability - an understandable discipline pursuant to which management is effectively responsible to some informed and effective force outside of its influence and control - in the United States, this is the shareholders.

2. Differences between what is meant by Corporate Governance in Japan and in the United States

When Mobil and Exxon, owning fifty percent of the stock, forced out Nobuyuki Nakahara as president of Tonen Corporation, the New York Times described the event as illustrating the difference between American and Japanese opinions as to what actions are appropriate for shareholders to take:

"By American standards, Tonen is a classic opportunity to go for the dough: that is, do what is necessary to retain market share while using the company's cash to enrich shareholders.

The Japanese tradition, however, would call for the company to accumulate cash and then look for ways to spend it later, thanking the large shareholders warmly from time to time for their support."

Governance, as we will have occasion to reflect frequently during these remarks, must be understood as a combination of appearance and reality. The general perception is that Japanese governance is hostile to shareholder interests: "Shareholders, often foreign ones, are fighting back against Japan Inc. This will be a long struggle: In Japan, the shareholder has forever taken a backseat to management. But the activists are pressing on. As a result, some governance specialists are voicing optimism-guarded though it may be - about shareholder rights in Japan." There is a mindset in the West about Japan's minimalist reaction to the need for change. This is echoed in the recent speech of Takeshi Yamaguchi, a partner at auditing firm Tohmatsu & Co; "But progress toward acceptance is slow, Japanese companies could be 20 years behind the United States in implementing such reforms… they know they have to be more transparent, but there are still too many things they don't want to be disclosed."

The reality, of course, is very different. Many prominent Japanese companies today have large percentages of foreign ownership. Even the most cursory student of Japanese history, since the days of the "black ship," cannot fail to be in awe of the country's unique ability effectively and quickly to adopt a changed course. In perhaps the finest writing available to Westerners about the "habits of the heart" in Japan, Ambassador Tatsuo Arima has put it best:

" …[O]nce the decision has been made, once consensus has been formed, the Japanese are perceived as functioning with swift efficiency. Many in the West, including even some Japan specialists, sometimes dance between two poles in their opinions, thereby reflecting this very process. One day they express their impatience with our domestic difficulties, the next day they express their awe at our corporate efficiency. It is, however, a much more integrated process that is at work today, for example, in the matters related to Japan's efforts to achieve its own so-called 'internationalization'."

3. Governance and Capital in Japan

There is great difference between corporate objectives in Europe, Japan and the United States. Peter Drucker recently wrote in FORBES magazine that the United States and the United Kingdom are the only countries in the world where companies are run for the benefit of shareholders. "..[W]ith the exception of the U.S. and the U.K., no developed country believes that the corporation exists for the benefit of the shareholder. This is a totally alien idea…. Corporate organizations exist in those countries for the sake of social harmony, for employment. In Japan the social reality is that the employees come first. In Germany too." I do not suggest there is anything wrong with the Japanese priority, but I echo the tensions recently expressed by Minoru Makihara in the FINANCIAL TIMES:

Among stakeholders in the company, workers rank as high as shareholders and that is good. It should be preserved. But it may not be possible.

As the current financial crisis abates and the banking system in Japan is restored to a viable on going basis, it is not clear - to an outsider - whether and the extent to which Japanese industry would like to return to virtually total dependence on bank financing. Their other alternative is to compete on world markets for capital. "The year 1998 may be the memorable year for corporate governance in Japan… Japanese companies face global competition and will be subject to more global standards whether they like it or not."

4. Economicus Americanus

The ECONOMIST has pointed out that the United States is unique in the world in being willing to subordinate all other societal considerations to economic competitiveness. No other country embraces change as a virtue and is so willing to cope with the dislocations of failed businesses. It would be an overstatement to say that American laws encourage individuals and corporations to declare bankruptcy, but there is little of the shame associated with commercial failure in other countries. The American political system has accommodated vast regional dislocations of manufacturers and employees. The polity has concluded that the benefits to consumers are more important than guaranteed jobs for manufacturers. Americans - on balance - have chosen to drive Japanese cars rather than to "protect" the jobs of American automobile workers.

The essential challenge of a capitalist system is change. Prosperity is a function of the ability to adapt to change. Trying to run an economy - or a corporation - in defiance of the law of change is like King Canute, the legendary figure trying to hold back the tides. This will inevitably result in the need to change business direction and to redeploy personnel.

Recent evidence from America concludes that those employees who were "downsized" in competitive restructurings actually got better jobs. This suggests, for America at least, that an employers' obligation towards his employees can best be styled as the commitment to provide them with employable skills. If the employer cannot sustain competitive viability, then his employees will have the chance to work for another employer who can. Only time will tell whether this phenomena is limited to the United States and to expansionary times. One critical component in this process is the creation of approximately 500,000 new jobs a year from venture capital investment.

Having said this, it must be clear that the American equilibrium will not be to the taste of every country - indeed, it is certain that many countries will have good reason to reject it. At the same time, one must recognize that the source of long term capital in the world increasingly comes from the pension funds of the English speaking countries. This suggests that the tendency will be towards standardization in the American direction. George Soros eloquently has argued that there must be limits to the unrestricted global flows of "hot money" and that unrestrained capitalism is currently the greatest threat to a "free society". "It is important now that the Japanese uncover their own globally acceptable standard of corporate governance, based on Japanese history and successes, not necessarily American." It is clear that Japan is entirely capable of creating a new kind of governance of corporations - and, once again, of developing the policies appropriate to reclaiming its position as a world leader.

5. The Role of the Shareholders

Governance in America is depicted as the concern of the shareholders - in particular, the increasingly homogenous and powerful institutional investors. This accords with the country's legal and cultural values that ascribe to owners' ultimate authority over corporations in recognition that they are ultimately at risk. Traditionally, owners were considered to be responsible for corporate functioning but - after being in abeyance for most of this century - this element has only recently been reasserted with the emergence of the institutions as majority owners of the largest publicly held companies.

The best contemporary thinking in the Anglo American world does not view shareholders as being more entitled to consideration than other corporate constituencies like employees, communities and suppliers. The critical shareholder role in governance is not a matter of merit or of morality. Ultimately, America relies on shareholders because they are the class which is best able to get the job done. The problems of "collective action" are well known - one member of the class takes all the chances, bears all the costs and only reaps their proportionate share of the rewards, if there are any. This lack of any cost / effective incentives intrinsically inhibits individual initiative. It is very difficult to imagine how employees, suppliers and customers could afford to organize themselves and function effectively as a group, when they are fundamentally dependent on the corporation for sustenance. Only shareholders, who are genuinely independent in the sense that they are not trying to buy from or sell something to the company, are suitable as a practical matter to enforce accountability. Only shareholders could change the governance of virtually the entire top tier of American business. It is this perception that is important in world capital markets.

Makihara appears to contemplate a parallel development in Japan:

I can see a time when a Japanese company will become truly global and be run by a non-Japanese. We are moving, inevitably in a globalising direction. In five or 10 years, when this recovery takes place, you will see Japanese companies paying much more attention to their shareholders, and I welcome that.

The challenge for Japan, in the event that Western reliance on shareholders does not accommodate local needs, is to devise and articulate another structure that unmistakably incorporates the principle of real accountability. The opinion of many customers in continental Europe caused Royal Dutch Shell to change its decision about disposing of the Brent Spar drilling platform.

6. Governance Myths

While people speak confidently of governance and the American accomplishments, it is well to understand the difference between appearance and reality. It is clear that American companies over the past fifteen years have become more competitive in world terms - in substantial wise because of the pressure of informed and involved shareholders. Eastman Kodak had virtually given up competing with Fujitsu early in this decade using their cash and credit to buy a drug company. Shareholder pressure forced the unrelated businesses to be divested and the management to be changed. Kodak has been able to move beyond its traditional technology and begin competing in a digital world.

There is no agreement, however, that a particular level or mode of activism is causally related to a particular improvement in corporate performance. The recent work of Paul MacAvoy and Ira Millstein is an encouraging beginning as "proof" of a correlation between an active, independent board and superior corporate performance. They adduce as surrogates for the holistic behavior of a professional board: (i) independent leadership through a non-executive chair or a lead director; (ii) periodic meetings of the independent directors without the management present; and (iii) formal rules or guidelines for the relationship between the board and management.

There is strong indication that alignment of the interests of management with those of the owners can be correlated with superior performance. Harvard professor Michael Jensen predicted the end of the publicly held corporation fifteen years ago in contrast to the results obtained from management Buyouts. The recent poll conducted by MITI in considering possible changes in the Japanese Corporate legal and governance system indicated a very high importance for performance based compensation. Toshiba's Nishimuro says "I don't want to go down all the roads taken by U.S. companies. We won't use stock options for our managers, because they don't reward effort since they don't necessarily reflect corporate activity when they rise or failure when they fall."

However, for all the attention paid to the American accomplishment in this field, it is appropriate and humbling to contemplate absolute failure in the field of executive compensation. It is not unknown for American CEOs to arrange no less than one billion dollars of lifetime compensation for themselves - Coca Cola, Disney, Travelers Insurance. Whatever else can be said about Corporate Governance U.S. style, it need be remembered that the most fundamental indication of accountability - how much the agent is paid to manage the principal's business - is out of control to an extent unique in time or place. It is plain for all to see that American top managers pay themselves too much and yet this "appearance" of hostility to ownership interests is subsumed by the realization that both parties benefit if the stock price goes up.

7. Some Respectful Suggestions

When one speaks of responsibility to shareholders, it is mere tautology to conclude that one cannot be referring to all shareholders. The preponderant source of long term financing is the Western pension fund - these shareholders have certain important characteristics - they are long term holders, indeed the index funds (possibly 20% of the whole) can be considered permanent owners; they have a wide commercial frame of reference because they own literally all companies in all industries in all OECD countries. Accountability to a long term universal owner permits - even encourages - a holistic definition of value sufficiently precise to satisfy the investors' needs at the same time as being spacious enough to incorporate Japanese accomplishment in "…alleviat[ing]…if not altogether eliminat[ing], the problem of alienation in modern industrial society." The appearance of "concern" with employees and societal needs is susceptible of articulation as compatible and essential to achievement of long term shareholder values. It may be that the process of fleshing out the definition of "value" will create a basis for governance in Japan that is compatible both with national values and international financing. The present anti trust suit in America against Microsoft can be understood as the expression of societal concern over the power of a single corporation - the government is asking Microsoft shareholders to have a more spacious view of their self interest in a free society. Some ingenuity will be needed in Japan to devise the best mode for effective communication with institutional investors - it is not an impossible task.

8. Conclusion

Governance is not a science - in America, the system of accountability to shareholders is promising; in other countries there may be other ways of achieving the same objective, but it is well to remember that the requirements of the world wide capital markets will tend to drive convergence towards uniformity.

What works in American doubtless will not work in Japan - there is only one element that deserves to be included in any workable scheme in every country. It must be clear that management is effectively held to account by some force - familiar and powerful, yet independent - outside of the corporation for the accomplishment of standards that have been clearly promulgated, understood and agreed. This and this alone will provide competitive access to capital.

Endnotes