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JAPAN'S SLOW EMBRACE OF OUTSIDE DIRECTORS

The pressure on Japanese firms to appoint more outside directors is increasing.

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Japan has long lagged much of the rest of the world in requiring outside directors on the boards of its listed companies. The United States was an early adopter of the practice with a majority of its directors being independent by the late 1980s. The issuance of the Cadbury Report in 1992[1] in the U.K. triggered a dramatic increase in the number of outside directors on the boards of U.K. firms, and a number of other countries followed suit by adopting similar requirements in the late 1990s. By comparison, less than half of Japanese firms listed on the first section of the Tokyo Stock Exchange as recently as 2010 had outside directors. However, the number of outside directors on Japanese boards has increased dramatically since 2010 — up to 62.2% in 2013 — and the trend is expected to continue.

CURRENT AND PROPOSED REQUIREMENTS

Under current Japanese company law, large companies[2] choose either to be a company with a board of statutory auditors or a company with a committee governance structure. Large companies that choose to have a board of statutory auditors, the traditional structure for Japanese corporations, are required to have a board of at least three statutory auditors, the majority of whom must be outsiders. However, statutory auditors are not directors and, therefore, have no vote on the board of directors. By contrast, the board of directors of a company that has chosen a committee governance structure must establish a nominating committee, a compensation committee and an audit committee, and each committee must be comprised of at least three directors, the majority of whom must be outside directors, requiring the company to appoint at least two outside directors. However, as of November 2013, out of more than 3,000 companies listed on the Tokyo Stock Exchange, for example, only 47 had adopted the committee governance structure. Thus, the majority of Japanese public companies that have appointed outside directors to their boards thus far have done so voluntarily.

However, it is looking more and more likely that appointing at least one outside director will soon become a de facto requirement for large public companies in Japan. Strengthening corporate governance, including through the appointment of outside directors, was mentioned as part of the Japan Revitalization Strategy that was published by Prime Minister Shinzo Abe on June 14, 2013. Partly in response to this, a bill was submitted to the National Diet in November 2013 to strengthen corporate oversight by independent directors. Although the bill does not actually require companies to appoint independent directors, it does require large public companies with a board of statutory auditors that have not appointed any outside directors to their boards to provide an explanation at its annual shareholders' meeting as to why they have not done so. Of course no company is going to want to be placed in this position, which is why the justice minister explained during a recent National Diet question and answer session that this rule will have the effect of essentially requiring large public companies to appoint at least one outside director. In addition, the Tokyo Stock Exchange adopted a rule in February 2014 requiring companies listed on its exchange to utilize their best efforts to include at least one outside director on their boards of directors, which has added to the pressure that publicly listed firms in Japan face with respect to the appointment of outside directors.

HOW EFFECTIVE ARE OUTSIDE DIRECTORS?

What is motivating this push for more outside directors and what will be the likely effect? A widely cited survey published in The Business Lawyer by Sanjai Bhagat and Bernard Black in 1999[3] found that there was no convincing evidence that increasing board independence would improve a firm's financial

performance. Rather, their survey of the literature found some evidence that firms with a majority of independent directors on their boards actually performed slightly worse than other firms. A follow-on study by Bhagat and Black in 2001[4] reached much the same conclusion.

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A January 2006 paper by Peter J. Wallison of the American Enterprise Institute for Public Policy Research,[5] also noted that the increase in independent directors did not seem to have a positive effect on the monitoring function (i.e., the ability to detect fraud or manipulation) of boards of directors either. Indeed, the anecdotal evidence suggests that independent directors are not always effective at preventing fraud, including such examples as the Enron scandal in 2001, where 11 independent directors on Enron's 14-member board were unable to detect massive accounting fraud, the WorldCom scandal a year later, where a board that consisted of a majority of independent directors was unable to detect massive fraud at that company between 1999 and 2002, and the 2011 Olympus scandal in Japan, where three independent directors were unable to detect one of the biggest and longest running fraud's in Japanese corporate history. Wallison speculates that the reason for this inability to detect fraud is precisely the quality that independent directors are prized for — their independence and resulting lack of access to information about what is really going on at a company.

On the other hand, Jeffrey N. Gordon argued in a 2007 article[6] that the explanation for the rise of independent directors, in the United States at least, cannot be understood by looking at the performance of individual firms, but rather should be viewed as the most effective way to govern firms so as to maximize shareholder value across the general market, and that the ability of independent directors to achieve this more efficiently than insiders reflects two important shifts over the last several decades. The first is the importance of stock price performance and shareholder value as the primary corporate objective, which can be more easily monitored by independent directors who are not beholden to management and its vision. The second is the increased informativeness of stock market prices as regulatory changes have resulted in an increase in disclosure requirements and a decrease in the significance of insiders' information regarding a firm's performance and its prospects.

THE NAIL THAT STICKS OUT...

Regardless of the cause or effect of the rise of independent directors, the shift throughout much of the world has been unmistakable. Regulators view them as a good thing and investors have come to expect them, which means that any jurisdiction that does not require them is going to be at a distinct disadvantage in attracting the world's capital. Indeed, it was recently reported that a total of 20 foreign institutional investors, including the California Public Employees' Retirement System (Calpers), cosigned letters to 33 leading Japanese companies in May urging them to increase the number of outside directors to at least one-third of the total within three years.[7] This kind of pressure is likely a key reason behind both the voluntary shift among Japanese firms increasing the number of independent directors on their boards and the Abe administration's push to make it a de facto requirement. Whether the shift will also translate into improved corporate governance, share prices or financial performance remains to be seen.

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1. The Committee on the Financial Aspects of Corporate Governance and Gee and Co. Ltd., , The Financial Aspects of Corporate Governance (1992).
2. A "large" company is defined as a company with capital of JPY 500 million or more or liabilities of JPY 2 billion or more on its balance sheet as of the most recent fiscal year.
3. Sanjai Bhagat & Bernard Black, The Uncertain Relationship Between Board Composition and Firm Performance, 54 Business Lawyer 921 (1999).
4. Sanjat Bhagat & Bernard Black, The Non-Correlation Between Board Performance and Long Term Firm Performance, 27 Journal of Corporation Law 231 (2001).
5. Peter J. Wallison, American Enterprise Institute for Public Policy Research, All the Rage: Will Independent Directors Produce Good Corporate Governance? (Jan. 2006).
6. Jeffrey N. Gordon, The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices, 59 Stan. L. Rev. 1465 (2007).
7. Overseas investors demanding more outside directors at Japanese companies, Nikkei Asian Review, Jun. 5, 2014.