An Examination of Corporate Governance Practices in Japan

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Japan's Keiretsu system

History of Keiretsu

When studying Japan's corporate governance structure one must first understand how Japan's companies are financed and structured within the stakeholder approach of their corporate structure. To begin to understand the keiretsu system, the zaibatsu system must first be explained. The zaibatsu systems, or "money cliques," developed during the Meiji Restoration in the 1866. These were family-owned conglomerates that came together to share business risk, with a bank serving as the major financier for the companies. Before WWII, there were 4 major zaibatsu: Sumitomo, Mitsui, Mitsubishi, and Yasuda. By sharing risk through the use of cross-shareholding and using parent banking, these corporate groups were able to maintain prosperity and production to aid Japan in WWII. This also created a problem for Japan after their surrendering during WWII. The U.S occupation under SCAP (Supreme Commander for the Allied Powers) targeted the zaibatsu as the cause of Japan's machine might and arguing that democracy could not exist with 25% of the nation's economy centered on a few groups (Anchordoguy, 1990). The SCAP also believed that the system threatened the civil authority with the ties to an empirical Japan. However, by the mid to late 1950s Japan's government activity encouraged the reestablishment of producer groups after the occupation left. This was done for two reasons; the first was to keep outsiders out of Japan (this is right after Japanese occupation), and to concentrate scarce resources that could be directed by the government into strategic industries. This allowed the economy to grow and the industry to grow to a size that was able to compete with the U.S. and British (Nordberg, 2011). This system became known as the keiretsu structure.

Currently there are six major keiretsu in Japan: Sumitomo, Mitsubishi, Mitsue, Daiichi Kangyo (DKB), Fuyo, and Sanwa. Each of these "families" is a horizontal keiretsu with vertical components within them. These are a bank-centered conglomeration that consists of about 182 companies under these six parent companies. These six major keiretsu earned 18% of the net profits for all Japanese businesses (Anchordoguy, 1990). This system allowed the families of the corporations to rely heavily on debt to finance their operations. These Japanese companies would have only 5 to 10% of equity capital, the rest being financed with debt (Nordberg, 2011).

Other companies would often hold the equity capital of one company in the same family so as to share the risk, with only a few outsider shareholders. This creates cross-stakeholders, which along with the financing of the banks, allows the companies to operate with very little equity capital to finance their expansion. The use of cross-stakeholdings also supplies some stability to the company and the managers, because these stocks are never traded. This allows the managers to focus on long-term issues instead of being worried about hostile takeovers (Anchordoguy, 1990). As for the shares of these companies, there are estimates that 23-42% of a company's holdings are held under reciprocal holdings. This does, however, create a problem for the shareholders. Not having the ability to exercise the exit strategy, they have to rely more on voice as a mechanism of control. The use of voice is also limited in the keiretsu system because the cross-shareholders have representatives on the board of directors, but the boards (anywhere from 30 to 50 members) are so large that there is a lack of influence for these members. Besides the equity holdings, there are personal exchanges between the companies such as board memberships, and personal exchanges such as “presidents council” (McGuire & Dow, 2009).

As for outsider stakeholders, there is no representation, and again the exit strategy does not work due to the lack of trading in this system. This lack of influence also creates a problem with the small amount of financing created by stockholders. They have to be very confident in the move before giving out financing. This causes the companies to be more conservative with their projects and to try to avoid risk.

For the most part, these companies continued into the 1990’s unchanged. Due to economic hardship and the 1992 economic decline that caused regulatory reform with the commercial code, the traditional six keiretsu have changed shape. Recent mergers in 2000 reduced the number of traditional keiretsu to four. Sumitomo and Mitsui became the Sumitomo Mitsui Banking Corporation, while Sanwa became part of the Bank of Tokyo Mitsubishi group in 2001 (McGuire & Dow, 2009). As these keiretsu have changed, the use of more regulation has been implemented. In 1993 the Commercial Code was introduced to move to a western style of corporate governance. This pushed for the reform of the board structure to include more outsiders and supplied rules on how the stock exchanges should work. By 2002, the Company with Committees amendment to the Japanese Commercial Code moved to a committee standard similar to the Sarbanes-Oxley Act in the United States. This amendment was not a mandatory move, but more of a recommendation that involved a comply or explain clause within it (Toda & McCarty, 2005).

Structure of Keiretsu

The article *Japanese Keiretsu: Past, Present, Future* by Jean McGuire and Sandra Dow does an excellent job of explaining the structure of keiretsu. As mentioned before, most keiretsu that come to mind are horizontal keiretsu. This structure is based on a central bank that finances different components within different industries. The most common one that comes to mind in America is Mitsubishi. This is a company that has its name on products ranging from automobiles to televisions. The reason many of these organizations came together was for five major benefits: access to stable financing, insulation from market pressures, risk reduction, monitoring benefits and reduction of information asymmetries, and mutual assistance. Most of these are self-explanatory. Mutual assistance comes from understanding that the executives and board members from one company have close personal connections, allowing them to discuss issues with other executives with a different perspective (McGuire & Dow, 2009). To understand the access to finance, the banks have first been looked at more as creditors, rather than shareholders, that emphasize low risk strategies and asset protection and encourage

borrowing. However due to the banks being used for credit, there is a premium in terms of over-borrowing and a higher cost of capital (McGuire & Dow, 2009). These allow the horizontal keiretsu to be successful in Japan.

Vertical keiretsu are easier to understand for Americans. These memberships are less diversified than the horizontal group. For vertical keiretsu, the controlling structure is a “core” manufacturing firm and its key suppliers at the center of the network. Then there are subsidiaries and smaller supply companies that exist on the vertical chain (McGuire & Dow, 2009). Due to there being a central manufacturer, instead of a central bank, there are not the reciprocal holdings as in the horizontal keiretsu. This allows the primary firm to hold shares in the suppliers while the suppliers hold a small portion, if any, of the primary firm On average, the core firm holds 32.8% of the suppliers’ shares, while it may only hold 11.4% of an independent firm’s share. This gives the organization more of a pyramid nature in the shareholdings. The main reason for this association is for stability of supplies to the core firm, while being able to control the actions of it suppliers. It also reduces the transaction cost encountered by coordination and communicating between the companies. Besides these benefits, the technical, managerial, and financial assistance lowers the cost of operating for the subsidiary firm. This also reduces the corporate governance problems, and there is some evidence for positive performance effects of the vertical affiliation (McGuire & Dow, 2009). When it comes to examples of a vertical keiretsu, Toyota and Honda are great examples. These manufacturers serve as the core manufacturing, and their suppliers are the subsidiaries. Due to the lack of reciprocal shareholdings, these boards tend to be smaller and do not have the same director crossover, but there are still representatives from the core manufacturing firm on the subsidiaries boards.

The article by McGuire and Dow continues to discuss the decreased use of bank financing in the current market and a move to more non-bank financing. Part of this change is caused by the regulatory reform that increased access to nonbank financing. Besides focusing on bank financing, there also seems to a decrease in vertical supply keiretsu due to an increase in number of quality suppliers created by the use of a global market.

The article then continues to discuss the decline in keiretsu using the transaction cost, agency theory, institutional theory and resource dependence theory. Due to globalization of business, and the increasing ability to seek financing through nonbanking needs, and to become similar to market norms, the keiretsu will decline in use in the future.

Boards of Directors

United States Boards of Directors

Within the United States, there are many requirements on the board structure. The first being board size. The United States requires that there is a minimum of five directors that sit on the board, and the majority of these directors have to be outsiders. Most companies have more than 5 directors, and ranges anywhere from 715 with the optimal board being round 10 members. In 2004 the average of 30 Dow Jones firms was 12.5 members (Toda & McCarty, 2005). The majority of these boards studied only had 1.8 insiders on the board, which was due to duality. With most of the requirement, the majority of the U.S. board members have to be outsiders. In the U.S. the definition of an insider is anyone that is working for the company or does a majority of their business done with the company. As for independence outsiders, the director cannot be on the payroll for activates other than the board, and have no executive title with the company. There are also grey directors, which have worked for the company in the past, or have had

inside information (such as auditors). The grey members do not count to the majority of the board being outsiders.

Within the United States board of directors, there needs to three committees: nomination, audit, and remuneration committees. The nomination committee is used to search for new CEOs, or new candidates for board members. The audit committee should be made up of independent outsiders, led by a financial expert. Their role is to monitor and control with the internal and external auditors and reports created by the auditors. The remuneration committee sets the composition for the TMT and should also be made by up of outsiders.

Diversity on the board of directors, is becoming more common now, but has still failed to reach a highly diverse composition. As discussed in class, the average director is a 56 year old white male. The leaves very little diversity in the board, but women are slowly beginning to join U.S. boards. Currently there are over 70% of the companies with one female on the board of directors, and females make up 16% of the directors in the United States. This allows the board of directors to have more innovation and different viewpoints.

With the board of directors in the U.S., voice in not a major mechanism of control due to the lack of ability to remove directors through voting. This causes shareholders to have to use exit as their mechanism of control to influence the board of directors into doing what they would like.

Japanese Boards of Directors

Within the brief discussion of the history of corporate governance in Japan, you can see that there have been many changes structurally and culturally within the Japanese corporate world since the governance reform in 2003 and in the further amendments that followed through 2006. In particular, this section will detail the structure, composition, and independence of the current boards of directors in Japan. Brief reference will also be given to current rules and regulations in place to govern Japanese boards and how they have changed over the years.

Board Independence

The number one issue that has arisen in Japanese businesses is the lack of independent, outsider perspective on the boards of directors. Currently, the average number of outsiders on the board is 1.8, with only 35% of the companies listed on the first section of the Tokyo Stock Exchange having an outside director (Nagata, 2012). According to statistics for the TOPIX 100 Companies, 21.5% of all directors are external, which is much lower than in the U.S. at 84% external directors (SpencerStuart, 2013). This is something the Japanese have been scrutinized for decades. Independent outsiders are said to provide oversight and control to an organization. Their unbiased opinions allow for effective administrative procedures. They are not driven by self-interest and thus hold the interests of all the stakeholders and the company itself at the highest priority level.

If having outsiders on the board provides so many valuable resources for companies, why haven't more Japanese companies adopted this practice? There are four main reasons according to Nagata. First, these boards argue that they deal with more small matters that require thorough knowledge of the company, which only insiders that contribute to. Essentially, they want directors who have extensive knowledge of the company and don't see a use or a need for anyone looking in on the company from the outside. Second, these boards hold more meetings, on average, than your typical U.S. board and deal with "day-to-day" matter that need little discussion. They don't feel like an outsider would be able to contribute to these daily

matters. Third, Japanese culture is very family oriented. Many businesses employ people for life once they hire them on. For this reason, it makes more sense for companies to advance employees to board member status once they have been with the company for a long period of time, have an excellent understanding of the company, and have shown their commitment to that company, its values and its goals. Their last argument states that because compensation rarely changes, directors focus on maintaining the "status quo" instead of making bold challenges to spur corporate growth. Members of the board who have been with the company for a long time understand that, while outside members would not understand why the company is not driven to increase the value of the stock for shareholders. Although these have been the standing arguments for decades, the reform has changed the minds a number of companies, and may have begun a trend toward increasing the number of outsiders on their boards.

Recent changes causing the reform have come about in order to maintain competitiveness in the global market, specifically with U.S., European, and Chinese firms (Toda & McCarty, 2005). This is especially true for Japanese companies involved in business overseas. A second reason is that there has been a dramatic shift in the composition of the shareholders in Japan. What used to be predominantly controlled by the bank in Japan and involved a lot of cross-shareholding between companies (mainly under the keiretsu) is now changing to ownership through institutional funds and by individual investors. Thus, there is an increased need for more public display of growth. Japanese companies must begin to focus more of their energy on the shareholders for the future.

The reform encourages companies to obtain more outside directors for their boards. However, the Japanese definition of an "outsider" is not explicit. In the U.S. the definition of an outsider is someone independent of the company, and cannot have or have had any relation to the company prior to becoming a director. In Japan, this is not the case. Their definition of an outsider is much less restricted than that of the U.S. In Japan, directors from a parent company, from a main bank or from companies with material relationships can be considered as outside directors (Toichi & Fukatsu, 2013). This is another obstacle that Japanese corporate governance regulations may be revising in the future.

The Companies Act of Japan was enacted in May 2006 to amend the Commercial Code of Japan. Essentially, the amendment made it possible for Japanese companies to have the choice to act more similarly to U.S. companies or remain the same in regards to corporate organizational structure (see section on brief history above). Two choices exist as far as the stance on outside directors are concerned. One lies with the Board of Corporate Auditors Governance Structure, which does not require that an outsider director be appointed to the board, but requires the appointment of at least two outside corporate auditors instead. The second, which aligns with the Committee Governance Structure, requires the appointment of at least two outside directors, but not an outside corporate auditor (Toichi & Fukatsu, 2013). In the end, it was decided that Japanese companies were not required to have an outsider on their board and could chose to do so as they see fit for their company. In regards to this, a "comply or explain" rule was put into place for companies that file annual securities reports to either appoint an outside director or explain why this process is inappropriate for their company (Seki, 2013).

Article #1: Bryant and Davis. "Regulated Change Effects on Boards of Directors: A Look at Agency Theory and Resource Dependency Theory." *Academy of Strategic Management Journal*, April 2012.

This article basically broke down the roles of a Board of Directors to two main roles: administrative and environmental. It then examined these roles and related them to two well known theories of corporate governance: Agency Theory and Resource Dependency Theory.

Administrative is more closely related to the independent outsiders on the board. Their main purpose is to provide expert advice and counsel to the firm's executives and monitor the firm's management through oversight and control mechanisms. The article directly related these duties to preventing the agency problem. There are two key ways to prevent the agency problem, and those are to "increase incentive structures that align interests of owners and managers" or to "increase monitoring, control and oversight of managers by owner-principal delegates." The second of which is referring to increasing the power of outsiders' role on the board of directors. The article summarized four main assumptions in regards to the Agency Theory that need to be addressed in businesses in order to minimize this issue. The first is that "wealth maximization is top priority for corporate owners." Simply put, people by nature are greedy and self-interested. Second, the "board of directors is an appropriate owner-principal delegate." It is their job to keep an eye out on the executives and minimize any conflicts of interest. This could, however, become complicated due to the fact that boards themselves can present with numerous conflicts of interest, especially if there are a high number of insiders on the board (i.e., Japan.) Third, "management and board actions and interactions are primarily outcomes of economic forces." This directly relates to the wealth maximization assumption, but does not take into account the social and political aspects of manager and board member relations. These social and political aspects are often what lead managers to become greedy and self-interested. Lastly, the "board of directors acts as a single unitary actor." This closely relates to the third assumption. As mentioned above, boards often do not act as a unitary actor because social, political, and psychological processes affect the individuals involved. In the end, this can lead to a number of differing opinions in board meetings that can cause feelings of stubbornness, resentment, and/or demotivation.

The environmental role of the board of directors relates more closely with the Resource Dependency Theory. Responsibilities of the board of directors under this theory include "providing access to information and other resources and enhancing perceived legitimacy of the organization." The essence of this theory is that a diverse board brings access to different resources; specifically, scarce resources like financing or non-easily substituted resources. Lastly, the article summarized the theory by proclaiming that organizations faced with greater resource dependence will maintain a larger board of directors with a greater proportion of outside directors.

Board Size

Speaking of board size, in Japan it has historically been very high, as high as 60 directors, in fact. The average number of directors on the board at one time was roughly 27 members. However, with the recent reform in corporate governance practices in Japan, that number has been significantly reduced. Based off of the TOPIX 100 of the Tokyo Stock Exchange (TSE), a listing of the "Top 100" companies in Japan, so to speak, the average board size is 12.1 directors, with 47% of companies having a board size ranging from 912 members. This number has become significantly more similar to that of the United States and United Kingdom over the years. However, it does not incorporate averages of smaller, rapidly growing companies. Typically, these Japanese firms will have a higher number of directors on their boards. This provides multiple backgrounds and expertise to come together to create innovative ideas to move the company forward and provide more guidance for the growing company. As firms age, the need for growth declines and, rather, levels out in a way. There becomes less of a need for

a larger board. That being said, smaller firms board sizes have still been significantly reduced since the reform and continue to decline in number just as in the larger companies.

Board Composition

The average age of a director in Japanese companies is 61.4 years while the average age for the Chairman of the Board is closer to 68 years (SpencerStuart, 2013). Although the average age for all board members in 61.4 years, when factoring out internal directors, the average age climbs to nearly 67 years of age. With the push to increase external (independent/outsider) directors of boards in Japan, there will continue to be a gradual rise in the average age of Japanese board members.

The average tenure for the chairman of a Japanese board is 3.2 years (SpencerStuart, 2013), while most directors on the boards will be on the board for decades. As mentioned above, while discussing insiders on boards, many Japanese businesses are family oriented and commit to lifelong employment. With the adoption of more and more outsiders on boards, however, this is likely to change.

Men historically dominate Japanese boards, not unlike in the U.S. Every single chairman of the TOPIX 100 companies in Japan is male (SpencerStuart, 2013). On top of that, Japanese boards have one of the lowest percentages of women on the boards of any other developed country. The average percentage of women on the board in developed countries is 11.1% (Ryall, 2013). However, Japan's average is no more than a mere 2%. According to SpencerStuart, in Japan, 27% of boards have at least one female director, which is very low compared to the 84-95% seen in the UK, U.S., Germany, and France. The majority (nearly 80%) of these females appointed to board positions are chosen as an external representative or as an outside auditor., whereas men in Japanese companies typically are brought up to director roles from inside the business. Like many other countries, Japan is working to increase the number of women on its boards. However, similar to the U.S., they have not yet declared a set percentage or timeline for these additions. However, the Japanese Prime Minister Shinzo Abe has declared that he wants every company in Japan to make it a goal to appoint at least one woman to its board. As a direct quote from Abe: "Women are Japan's most underused resource."

Article #2: Zhu, Small, et al. "An Examination of Female Participation on U.S. Board Subcommittees." *Journal of Business and Management*, April 1, 2010.

The above discussion brings us to our next article relating to women in executive roles, specifically as members of boards of directors in the United States. The article begins by relaying some interesting statistics (from 2008) relating to women in the workplace in the U.S. Women represent 46.5% of the total U.S. labor force with 39% of those working in management or professional positions. According to the article, women also "account for 51% of all workers in high paying management, professional, and related occupations but are still underrepresented in the highest echelons of the corporate world." This is true even though the number of companies without a female on its boards dropped by nearly 50% between 1995 and 2005.

The article then brought to light a very validating point about females being added to boards. Board diversity is an issue, and many companies are willing to do whatever it takes to make them appear well diversified in the public eye. What does this mean? It means appointing women to executive roles and board positions to "maintain a positive image with shareholders and to signal the companies' commitment to board diversity." Therefore, their place on a board is simply to represent a diverse population to gain respect from shareholders and bump up their

stock price. The authors of the article hypothesized that women are often not appointed positions on the most powerful committees of the board, and "if they were truly valued members of boards, they would be significantly represented on these committees as well as on the boards of directors."

Overall, they examined a few arguments for women on boards and some arguments mentioned opposing this. The following are some of the advantages that women can bring to boards that would differentiate themselves from men on the boards: a better representation of the firm's customer base, suppliers, and employees (more reflective and better at meeting market demands), variety of perspectives, enhanced problem solving, creativity and innovation (based on beliefs and cognitive function), and improved monitoring due to increased independence. Opponents argue that women lack necessary experience that would make them desirable candidates relative to men. The irony is that if companies began to allow more women on boards to gain this experience now, this argument would not stand 10 or 15 years down the road. Present women with opportunities and let evolution take its toll. The article went on to further hypothesize that men would be better suited for roles in the audit, compensation, executive, and finance committees, while women would be better suited for public affairs committees.

Utilizing experience-based controls, the study used a variety of techniques and equations to evaluate the likelihood of a male versus a female being appointed to one committee or another. They conducted an aggregate-level analysis as well as a firm level analysis. The aggregate level analysis consisted of 4,913 firms and the firm level encompassed some 50,645 firm-year observations spanning from 1999 to 2004.

The final discovery of the article was that women were more likely to be members of the audit and nominating committees than the compensation committee. Overall, it was indicated that a female is 9.6% more likely than a male to be on any of the three committees. However, they were 5% more likely to be on the nominating committee and 6.7% more likely to be on the audit committee. On the other hand, females were 4.5% less likely to be on the compensation committee. It was also determined that when there were a high number of insiders on the board, women were less likely to be appointed as members of these core committees.

An additional interesting finding was that larger, more established firms were more likely to have female committee members while rapidly growing firms were less likely. It was found that for every additional $1 million increase in firm size, it was 1.9% more likely that that company would have female appointed to committees. If female members already exist on the company's committees, then that percentage jumps up to 3%. On the other hand, when rapidly growing firms are looked at, female core committee membership is 6.8% less likely when looking at all firms and 9.7% less likely for firms who already have board membership.

Director Compensation in the United States

During the past decade, we have witnessed both a dramatic increase in the demands placed on directors of public companies and the scrutiny of boards' actions. While the fundamental model of a director's fiduciary duties under state law has remained mostly stable, in other precincts – including the Securities and Exchange Commission and other regulators, ISS, institutional investors, politicians and the public – expectations about directors' involvement and influence over a corporation have increased significantly.

An engaged, skilled and thoughtful board of directors adds immense value to a corporation. It is more difficult than ever to recruit and retain directors who meet the requirements – including the increased legal and regulatory requirements imposed within the past ten years – for experience, expertise, diversity, independence, leadership, collegiality and character. Competition for the best candidates is intense, particularly in view of the fact that the ideal director candidate is often a successful, independent and prominent person who does not need the exposure to the obligations that public company directorship entails.

Director pay has historically been limited by the view of the director as holding an independent trust and, once upon a time, the relatively limited time commitment that board service was thought to entail. More recently, boards have generally been wary of increasing their own pay in light of the downturn in the economy and public perception. The result is that levels of director compensation have not kept pace with the realities of the current marketplace. While directors are not employees and compensation is not the main motivating factor for public company directors, given the importance of board composition and the competition for the best candidates, it is important to evaluate whether these programs are appropriate to the company's needs. Accordingly, as boards go through their self-evaluations, it is worthwhile to evaluate whether director compensation programs need adjustment consistent with the increased demands of board service, and whether they are adequate to secure top notch directors.

Companies should give careful thought to the mix between individual meeting fees and retainers. Business and regulatory demands have deepened director involvement and technology has changed the way directors meet. In view of this, there has been a de-emphasis on per-meeting fees and a concomitant increase in retainers. This simplifies director pay and avoids issues that arise from electronic forms of communication and frequent, short telephonic meetings. As companies move away from per-meeting fees to retainer structures, they should consider whether additional retainer pay is appropriate for directors serving on committees that impose substantial extra demands. It is also appropriate to consider the level of time commitment required outside of meetings, including for members of audit and compensation committees who must frequently review substantial written material to be properly prepared for their meetings.

The increased responsibility imposed on directors generally is especially pronounced for nonexecutive board chairs, lead directors and committee chairs. Accordingly, particular attention should be paid to whether these individuals are being fairly compensated for their efforts and contribution. While it is not uncommon for nonexecutive chairmen to be paid more than other directors generally, almost half of nonexecutive chairman and lead directors receive no premium for their service in these roles, and the average premium for lead directors is just 15 percent according to a recent survey from the National Association of Corporate Directors. We expect the pay of nonexecutive board chairs and lead directors to increase significantly as pay practices catch up to the demands of the responsibilities of these positions. Survey data will prove useful in considering appropriate director compensation.

The importance of collegiality to the proper functioning of a board of directors must be kept in mind; director compensation should not promote factionalism on the board. Differences in compensation among directors should be fair and reasonable and reflect real differences in demands placed on particular directors. Although many companies allocate responsibility for setting director pay to the compensation committee, director pay is different from employee compensation and occupies a position of unique importance to the company. It is a fundamental element of corporate governance. It is also a good idea for director compensation to remain analytically and conceptually distinct from the question of executive pay. Companies should

consider whether responsibility for director pay is better delegated to the company's corporate governance and nominating committee. In any case, the decision with respect to director compensation should always be subject to overall board of directors review and approval.

Cash retainers vary from a low average of $21,138 for commercial banks to a high of $78,848 in the retail trade industry. The same industries represent the two ends of the spectrum for stock awards, which vary from a low of $13,891 in commercial banks to a high of $97,742 in the retail trade industry. In addition, some variation exists within industries: for example, as many as 10% of 19 financial services companies annually award to each of their directors as little as $11,200 in cash. Board compensation in the energy industry shows the largest difference ($265,600) between the 10th and 90th percentiles. Board members in the chemicals industry and in the computer services industry received the highest total compensation ($184,115 on average).

Larger companies (by annual revenue and asset value) awarded substantially higher cash retainers and total compensation to board members than smaller companies. Companies in the smallest category measured by annual revenue awarded directors $60,000 in cash retainer at the 90th percentile. This amount is much higher in the largest companies ($110,000). Median total compensation ranges from $46,843 in the smallest companies to $190,000 in the largest companies. Both measures of compensation show a direct correlation with asset value as well.

When it comes to compensation mix, computer services is the industry with the lowest percentage of total director compensation awarded in cash retainer (26.6 percent). However, it is also the sector that placed the greater emphasis on equity based compensation (stock awards and stock options), which surpasses 70 percent of the total. Directors at smaller financial companies (with assets valued at $1 billion or less) were, on average, compensated more in cash, while larger financials were more likely to compensate their board members in stock and stock options. Across all industry groups and revenue and asset classes, most companies awarded board members additional funds to serve as members of major committees. As with other measures of compensation for executives and board members, the amount of these additional awards increases with company size. For example, in companies with annual revenue of $5 billion or greater, compensation for the chair of the audit committee was $18,242, compared to $6,583 for those with revenue under $100 million, on average.

Stock Ownership Guidelines

Across industries, a large majority of companies adopt formal guidelines requiring minimum stock ownership for board members. When in place, those guidelines may require board members to acquire, over a certain timeframe, a minimum number of shares, a minimum dollar amount worth of stock, or a multiple of the annual retainer worth of stock. Among surveyed companies, the most widely used type of guideline is the one based on a multiple of the annual retainer. When adopted, stock ownership guidelines are almost always disclosed to the market.

Compensation Benchmarking Disclosure

More than three-quarters of surveyed companies indicated that their proxy statement contained the names of individual companies composing the peer group used for executive compensation benchmarking purposes; the larger the company size, the higher the percentage of companies providing this type of disclosure. The compensation committee is most frequently charged with the responsibility of determining the compensation peer group. However, 45% of manufacturing companies and 47% of nonfinancial services companies reported that their senior management was also directly involved in the selection process. Industry and company size are the most

frequently used features to identify the companies that should be included in the compensation peer group: the larger the company size, the more relevant these features become to the selection process. Across industries and company size groups, annual base salary is the aspect of senior executive compensation that is most tied to the analysis of the compensation peer group. However, 23% of manufacturing companies use compensation peer benchmarking to determine annual equity-based incentives, and 12% for cash-based bonuses contingent upon performance.

Compensation Risk Disclosure

Across industries and size groups, a large majority of companies, after reviewing its compensation policies and practices, concluded and disclosed that such policies and practices are not reasonably likely to have a material adverse effect on the company. Most often, the disclosure on compensation-related risk is included in the Compensation Discussion & Analysis (CD&A) section of the proxy statement. In particular, this is the case for 82% of financial services companies with asset value between $10 billion and $99 billion. Companies reported adopting a wide array of measures to mitigate compensation-related risk. Across industries and size groups, the most widely cited mitigation measures are multiyear vesting periods for equity grants (used, for example, by 76% of surveyed companies in financial services) and an executive compensation policy requiring a mix of cash and equity and of an annual and longer-term incentives (84%, also in financial services). Often, such measures are combined with others, including shareholder guidelines requiring employees to retain award shares for a specified period or through retirement and a cap on maximum incentive award payouts for top executives. The least cited among mitigation measures is the use of performance review processes where the evaluation is conducted over an extended period of time as opposed to only annually (20% of financial services companies). Not surprising, for the greatest majority of surveyed companies, the duty to assess and oversee compensation-related risk is formally delegated to the compensation committee.

Compensation Consultant Fee Disclosure

Of the surveyed financial companies, 59% reported in their 2010 proxy statements the names of the compensation consultant(s) from whom they obtained advice. The number of reporting companies increases to 72% and 80% of the largest size groups measured by annual revenue and asset value, respectively. Not surprising, for the greatest majority of surveyed companies (and virtually all companies across industries), the compensation consultant(s) were retained by the compensation committee. Across industries and size groups, a large majority of companies did not disclose the aggregate fee paid during the reportable fiscal year for compensation-related services and for additional consulting services, since the fee amount was lower than the $120,000 threshold for which securities laws mandate disclosure.

New Study Covers Outside Director Compensation

Hewitt Associates recently released an analysis of compensation programs for outside directors at 708 public companies (average sales volume $12.5 billion, median $3.4 billion), the data drawn from public documents between January 1 and December 31, 2009.

Executive Compensation in Japan

Executive compensation is a mechanism used to align the executive's decision making with the interests of the shareholders and the broader stakeholders. Executive compensation has been a hot-button issue over the past decade due to the economic downtown, financial crises, CEO scandals, and government bailouts. Executive compensation varies significantly from company to industry to country. The executive compensation practices of Japan are much different from those of the United States discussed earlier, but they have been changing drastically.

After World War II, Japan was left in devastation. The 1950's marked a time of major rebuilding in both infrastructure and wealth for the Japanese nation. One way in which Japan built itself back up rapidly was through the creation of "keiretsu" groups. Keiretsu groups can be defined as groups of independently managed companies that maintain close economic ties, brought together by governance mechanisms such as cross-ownership and interlocking directors (Grabowiecki, 2006). During this high growth period, keiretsu groups became Japan's source of competitive advantage. Japanese companies used primarily debt financing from their banks, which were the hub of the transactions in the keiretsu group, as they were reluctant to trust outsiders. High levels of debt meant that bankers played a key role on the board of directors and so did members of other keiretsu companies. This caused outside shareholder's to have little influence on the company.

Over the last decade, Japanese companies have seen a change of ownership structure take place. Japan went from a cross-shareholding model or "relationship-oriented" system to more of a foreign ownership or "market-oriented" system. Prior to 2002, the board was made up of only statutory auditors and committees were not permitted. Executive pay was proposed by the directors themselves and decided on at the annual meeting of the shareholders. In 2002, there was an amendment made to the commercial law that allowed Japanese companies to have a committee system structure for audit, nomination, and compensation. This amendment stated each of the boards had to have three outside directors. Since the adoption of the committee system, foreign ownership or the corporate governance mechanism of "market-oriented" has soared by 23.9% in 2010 (Sakawa, 2012). Japanese boards have few nonexecutives and even fewer outsiders. Japanese board members determine their own salaries with help from the remuneration committee, and these represented at the annual shareholder's meeting. Their pay is accounted for separately on the profit and loss statement and is not included in the wage and salary statistics (Waldenberger, 2013).

Part of the reason the Japanese corporate governance system is shifting from relationship- to market-oriented is due to the increased foreign investment in Japanese companies. With this shift in foreign investment, also comes a shift in executive compensation. Foreign investors expect to see a linkage between firm profitability and executive compensation in order to incent managers to improve their investment returns. On the other hand, Japanese shareholders like the banks or members of the same keiretsu group who are business partners with long time relationships, wish for other incentives because they benefit more from sales growth of their partner firms. Although both foreign and domestic investors care about firm performance, their economic concerns differ (Colpan, 2012). Firms with the market-oriented, foreign investment corporate governance system tend to pay executives with more stock options and link pay to performance. Firms with more relationship-oriented, domestic investment tend to offer executives more bonus incentives with links to accounting profitability and for tenure and years of experience.

For many years, executive compensation was made up of primarily fixed salaries and an annual variable cash bonus. Stock options were not introduced until 1997 when the commercial code went through reform. In 2002, performance-based pay was further deregulated, allowing companies more options to compensate on performance. Prior to 2006, stock options and bonuses were not considered expenses for companies. After 2006, companies were allowed to count these as expenses and stock options became more widely used but have not changed the Japanese compensation structure much at all (Waldenberger, 2013). Only one-third of Japanese companies offer stock options and these are promoted heavily by foreign investors. In a study by Sakawa et al. (2012) of 312 directors within 200 listed stock companies, where each reported over 100 million yen in earnings, the average incentive of 22% of total compensation was made up of 16% bonuses and 7% stock options. The monthly or annual bonus is still the main form of performance sensitivity, and that is still relatively small at only 16%. That leaves 78% of pay to fixed salary. In the US, only around 29% of CEO pay is fixed, and 71% is variable in stock options or bonuses (Waldenberger, 2013). The Japanese executive compensation package does not include the "high class" incentives found in western countries.

In comparison to American executives, Japanese executives receive one-fifth of their executive compensation after adjusting for firm size (Waldenberger, 2013). In Japan, much like the US, a very important determinate of CEO pay is the size of the company. In the US, CEO pay increases around 30% with the size of the company, and in Japan CEO pay grows around 21% with the size of the company. One of the reasons for lower executive pay in Japan is due to the smaller company sizes. However, the most important determinant of pay in Japan is said to be the internal labor markets, which are the core of the Japanese employment system. In the midst of the rapidly growing Japanese economy starting in the 1950's, labor markets were born. Labor markets are defined by the three pillars of "lifetime employment," "seniority wages," and "company unions" (Waldenburger, 2013). It is these internal labor markets that bring in college graduates after a yearlong recruitment process, and groom them over a 30 year employment term to executive status. In a 1998 study of large Japanese companies, 82% of senior managers on the top management team, had never worked for another company, compared to 19% in the US (Waldenberger, 2013). Japanese workers have extreme loyalty to their companies, which also causes in return top management positions to be filled internally. From 2000-2009 only 4% of Japanese CEO's were appointed from outside the company, as compared to over 25% in North America (Waldenburger, 2013). In comparison, the US has an external, highly competitive labor market with many more executive opportunities. Because of this loyalty, Japanese companies do not need to focus on long term incentives in executive compensation packages. Employees are intrinsically loyal without the incentive.

Executive compensation is also in part determined by employee salaries in Japan. The majority of companies in Japan adjust the fixed portion of executive's compensation annually to adjust for firm performance, industry conditions, and increases in employee wages (Waldenberger, 2013). Through this, executive compensation is said to be determined vertically in Japan. In the US, executive compensation is based more upon a horizontal line because it is more competitive based on talent, firm size, industry, and opportunity. In Japan, because of limited opportunities as well as intense employee loyalty through lifetime employment seeking, Japanese executives will earn less than executives who move freely between companies. In the US, the ratio of CEO to average worker pay was 354:1 in 2012. The average CEO pay in the US for 2012 was $12.3 million, whereas the average worker pay was $34,645. In Japan, the average CEO pay in 2012 was $2.4 million and the average worker pay was $35,821. Japanese CEOs make 67 times more than the average worker. This means Japanese CEO's are paid 56 times less than American CEO's (Salazar, 2013). Executive pay in Japan is also determined upon accounting profitability or ROA, unlike in the US where executive pay depends more upon

the stock price or profitability within the industry. In a study conducted, Japanese bonus pay increased by 5% for a 1% increase in ROA (Waldenberger, 2013). There was no significant increase in Japanese executive pay for stock price movement.

Japan has a relatively weak pay for performance sensitivity. This means incenting executives with stock options or bonuses for increasing company stock price, does not actually increase the stock price of the firm. One reason for this weak link between executive incentives and increasing stock price is the decreasing effect of keiretsu, which used to serve as a monitoring mechanism for Japanese companies. Another reason for weak pay for performance is the high debt financing, which has reduced the likelihood of using the stock option. One mechanism that would increase the pay for performance measure is increased corporate, institutional, and foreign ownership (Waldenberger, 2013). Perhaps the most important pay for performance mechanism, and the most difficult to measure, would be employee loyalty, which can be defined as 30-plus years of service, with a large, close network of personal relationships with peers and subordinates. These close social ties and loyalty can be said to be an internal substitute for outside monitoring.

One issue Japan has struggled with in regards to executive compensation is transparency. Transparency in executive pay can help curb the agency problem. Prior to March 31, 2009, Japanese companies were not required to publicly disclose the amounts paid to executives. Japanese companies were allowed to report the sum of all cash salaries and bonuses for directors combined. This made it impossible to determine the exact amounts paid to each executive and made research on executive compensation in Japan very difficult. Only through reviewing personal tax return information was one able to get an idea as to the amounts paid to executives in a particular company. On March 31, 2009, the Japanese financial agency or FSA released a guideline urging all companies to publicize the compensation of any executive earning over 100 million yen (Sakawai, 2012). However, items such as health insurance, pension benefits, and special allowances do not have to be reported.

After the amendment in 2010 urging companies to publicize executive pay, research was done for the first time on executive compensation in Japan. The research showed that unlike the 1990's, bank ties were no longer effective at solving agency conflict and did not substitute for incentive compensation. It also showed that the role of incentive compensation is effective for companies with a higher degree of foreign ownership. The research also showed the companies that adopted the committee system including the compensation committee only facilitated short-term incentive packages, because directors were only allowed to serve one year on the committee. Long term incentive packages tend to come from outside directors, rather than internal directors (Sakawa, 2012).

Sustainability

The Ministry of the Environment of the Government of Japan is the equivalent to the US Environmental Protection Agency. The ministry is divided up into various parts that cover areas of environmental protection such as waste management and recycling, environmental policies, and the environmental health department. The Japanese suffered through a severe earthquake in 2011 that brought about a lot of damage to the country as well as contamination with so much of the debris falling into water and other hazardous material. One of the ministry's developments has been the cleanup of the damage from the earthquake. There are various dimensions to the environmental sustainability of Japan and the articles discussed will look at various parts of it to better understand the ideas and attitudes in the country.

Translating Sustainable Development: The Greening of Japan's Bilateral International Cooperation

The first article discusses the trend of "greening" of Japan's bilateral international corporation. The term "greening" is defined as "a political process in which existing policies, institutions, and practices are reformed in order to incorporate environmental considerations including the concept of sustainable development" (Kim, 2009). Much of the movement towards "green" efforts has been attributed to donors. These actions can be explained by their reflexive behavior that looks to understand the successes and failures of past practices, which helps them analyze the costly nature of recovering mistakes made from past practices. Japan has been looking at new ways to make "green" practices a more significant part of their corporate practices.

The JICA (Japan International Cooperation Agency) was the first Japanese aid agency whose responsibility it was to respond to global green trends. They worked to enhance the significance of environmental consideration in aid projects. One of the means by which JICA is able to maintain green practices is through the development study of kaihatsuchosa. This study is carried out by hired consultants and helps JICA's organizational structure and policy become more and more green which in turn has a direct impact on the quality of a project's environmental consideration. They have worked hard to maintain green structure throughout Japanese business practice, but environmentally destructive projects still come up many times because of the ambiguity and vague nature of some JICA guidelines. Another hindrance to quality performance of JICA is the lack of staff that they have available to go into the field to perform the environmental studies necessary to provide the best aid in greening of practices. The limitation that JICA faces has led them to work more with private sector firms in their development study activities.

The OECF is another organization that is similar to JICA that helps other countries assess their environmental impact before proceeding. They work by assigning a category to projects depending on their potential for environmental impact and this organization also required the submission of an EIA (environmental impact assessment). Since its beginning in 1988, the OECF has made its procedure for an assessment of environmental impact of a project more rigorous so that they can ensure the implementation and administration of environmental consideration for a project. The organization's environment and social development section has grown substantially, but the OECF remains understaffed. This issue of being understaffed in the greening organizations of Japan seems to be an issue that requires attention so that their efforts can be sustained in the long run and Japan can push for more sustainable practices.

Japan's movement towards environmentally sound practices can be noted in their greening of international cooperation agenda. Japan's modernization as of late has caused high rates of industrial pollution, which has caused them to focus on pollution or "brown" issues. A pollution related disease outbreak in Japan in the 1950's led to major advances in their environmental technological capacity. With organizations like JICA and the OECF, the developing of technology to handle pollution and waste management in Japan was greatly appreciated by many as it would help Japan grow to be more environmentally stable and then those technologies would be easily transferrable to other countries. The aid that these organizations provided to other countries is also beneficial to Japan because the pollution in places like East and Southeast Asia was directly affecting Japan. Japan was experiencing acid rain and increasingly frequent and intense "dust and sand storms", so this aid and greening of their own practices was that much more important.

With all the efforts of organizations such as JICA and OECF, there have been observable changes in Japan's green practices. JICA's objective is to aid in the development of developing countries like Japan with international cooperation to make sure the development is sustainable. Though they are working hard in these efforts, they do not go without their fair share of obstacles to overcome. One of the biggest constraints was the organizational issues that resulted from staffing and budget shortages. These issues that arose for environment related tasks ultimately hindered the quality of environmental consideration activities. The issues with capacity that these organizations faced led to "greater reliance on private consulting companies that often are larger Japanese corporate subsidiaries with cozy relationships with political and economic elites in recipient countries" (Kim, 2009). This unfortunately led to a political-economic influence over the EIA process which makes it more difficult for proper greening processes to take effect.

Sustainability of Urban Water System: Examples from Fukuoka, Japan

This article looks at the urban water management policies in Japan. Using Fukuoka city as an example, they describe the potential for sustainability opportunities in Japan's water system. The city of Fukuoka is situated in southwest Japan and receives an annual precipitation of 1,600mm. The city has experienced severe water shortages about 11 times in the past 100 years. This can be extrapolated to relate to a majority of other places in Japan as well. Because the city suffers from water shortages so often, water conservation and management are increasingly important.

Fukuoka municipality handles many of the water shortage issues. The Fukuoka City Waterworks Bureau (FCWB) handles the water supply in the city and the Fukuoka City Sewage Works Bureau (FCSWB) handles the responsibility for wastewater. One of the ways in which the municipality deals with water shortages is through controlling of water demand. Water charges for citizens increase considerably as the amount of water usage increases, so the municipality has encouraged such practices as the use of alternative water sources (i.e. rainwater, reclaimed wastewater) for larger buildings and such. Investing in water distribution efficiency is another means in which the Japanese city works on water management. Water purification plants were combined so that water could be evenly distributed when one area ran out of water. The increase in management and leadership that is necessary to make these changes possible helps create a more positive economic outlook for Japan as well. The people of Fukuoka city have also begun to use the Fukuoka Dome as a means of catching rainwater to be used as an alternative water supply because the roof of the sports arena was constructed in a way that allowed for maximum water capture and use. The shopping complex called ACROS Fukuoka is also being used as a means of harvesting rainwater during the Japanese rainy season to provide a water source for the building itself, as well as the surrounding area in Fukuoka city.

The demands that potentially come from the development of a sustainable water system can be categorized into four demands. The first is for basic functions that entail providing water for daily use that allows the Japanese citizens to perform daily tasks and functions that require the use of water. Another demand would be for the use of natural resources/the environment which means "all resources flowing within the system receive attention and efforts are made to reuse and to close loops of element flows, minimize waste and energy consumption" (Berndtsson & Jinno, 2008). With this process, they also take into consideration the use of natural resources for future generations, which encourage better conservation. A sustainable urban water system would also benefit the economy and organizations as it would allow them to be self-sufficient in the short run by being able to finance system's maintenance and benefit from the large scale production of water system equipment. It would also allow them benefit economically in the long

run by being able to finance investments and new developments. A proper urban water system also provides flexibility because it would allow Fukuoka City to adapt to new external conditions and new demands of the consumer.

When looking at the problems with water shortage and conservation in Japan, the studies done in the article show that though innovations such as the utilization of the roof on the Fukuoka Dome and Fukuoka ACROS will help catch rainwater to be used by the city, more needs to be done to try and implement a better urban water development plan. The water and wastewater sectors of the Fukuoka municipality serve as two separate departments, but this author believes that having both combined into one big department will push more focus towards the utilization of wastewater and provide more resources to the waste water department. This would in turn give the department the means for more growth. The development of these means by which Japan can save water will also be very useful in helping the people maintain their cultural traditions that they are accustomed to practicing.

Why Japan's Development Aid Matters Most for Dealing with Global Environmental Problems

This article by Monir Hossain Moni (2009), looks at environmental sustainability practices of Japan and how it relates to political situations in the country as well. Japan is the 5th biggest emitter of greenhouse gases in the world, which is why they receive a substantial amount of criticism for contributing to global warming. They have received a great deal of criticism also in the realm of cooperative partnerships for environmental help. They have a tendency to not get involved with multilateral partnerships. They also tend to focus more on loan finance for infrastructure projects to provide aid to other countries, rather than the more appropriate "pro poor policy and self-help grassroots assistance schemes". Despite this criticism, Japan has begun to increase environmental safety and development efforts in its own country as well as others. Bilateral environmental aid has grown over 370% since the 90's and Japan is considered of the world's leaders in bilateral aid. The negative towards their efforts in bilateral environmental aid is that it is being perceived as having an alternate agenda. They do much of their work in oil and gas rich countries which seems as though they are proving aid in hopes of spreading Japan's global prestige or to facilitate future trade ties.

Despite these many criticisms and questionable motives, Japan is considered of the world's leaders in environmental aid internationally. They have helped numerous countries in mitigating their environmental issues so that they are able to grow and develop without overly affecting the environment. They have shown a great deal of initiative in these efforts and the Japanese government created the Kyoto Initiative, which provides Japanese support for global warming initiatives in addition to traditional environmental programs. Japan has also become the second greatest financial donor to the UN, being almost one-fifth of the UN's total expenditure. This further emphasizes the important role Japan plays in the sustainable development of other countries. They continue to work on improvements in their country as well as their international neighbors as well.

Corporate Japan has seen the bilateral environmental aid that Japan has been providing and they see some win potential in pursuing pollution control and global environmental protection. Part of the reason for this is because MNC's (Japanese multinational corporations) are under much scrutiny from environmental groups to boost their environmental image. Corporate Japan has been particularly active in the East Asian region and they have made positive environmental impacts on timber management in the context of Southeast Asian political economies. Japan's ODA (Official Development Assistance) has helped trigger many reforms in climate change and

environmental laws and policies in numerous other countries. They provide excellent lessons because of the many things to be learned from their own domestic development. They have made great strides in the policy and law making of their own economy for sustainable development. Because of the work they do for other countries as well as their own, some citizens of Japan have been offered international environmental excellence awards for pollution prevention. As previously discussed, they have become frontrunners in the global market for environmental sustainability and this leadership on the global scale is what would greatly accelerate Tokyo's aid effectiveness and thus eventually bring benefits to the nation's sustainable development as well. These international efforts don't directly affect Japan initially, but point to the larger issue at hand. In the 21st century that we are in, environmental issues don't just affect a single state/country alone. They are issues that eventually affect people on a global scale. This makes global ODA efforts that much more important as the "business" done in other countries will hopefully come back to help Japan in return. Making a difference globally, eventually comes back to help Japan in the future.

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