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Reflecting the transformation of the capital market, corporate governance in Japan is undergoing dramatic changes. While the development of the framework for corporate governance, such as the introduction of the executive officer system, is showing some progress, it would appear that the principle objective—i.e., building a management system that increases benefits to stakeholders—has not necessarily been achieved.

To make corporate governance function in Japanese companies, improving the M^3 parameters will be necessary. These are measurements (creating the information on which to judge management and financial performance), monitoring (developing the hardware and software for business monitoring), and motivation (providing more incentives for management to increase corporate value). Once these reforms have been implemented, an application system can be developed.

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I Transformation of Corporate Governance

1 Globalization and Borderless Capital Markets

The common view of corporate governance has traditionally respected the individual systems of each country. Recently, however, a set of global standards for corporate governance is being advocated. For example, the Organization for Economic Cooperation and Development (OECD) compiled guidelines on corporate governance in 1998 and 1999. In response, the International Corporate Governance Network (ICGN)[1] adopted its "Global Corporate Governance Principles" in 1999 (see Table 1). There are two interests underlying this international debate on corporate governance: the viewpoint of the investor and the perspective of the corporation. For investors interested in pursuing globally diversified investments, it is not desirable to have a system in which shareholder rights vary from country to country. Moreover, if decision-making organs such as the board of directors are essentially different among various countries, it will be impossible to ensure a management system that strives for continuous profit increase. At the same time, corporations aiming at raising funds globally must establish a management system directed at producing continuous profit for the benefit of stakeholders in order to win the trust of investors. In other words, it must provide accountability.

In retrospect, it was recognized that corporate governance in Japan attached importance to maintaining a balance among stakeholders, such as key employees, creditors led by the main bank, and the government (backed by regulations and administrative guidance). However, corporate governance has recently been undergoing a gradual shift in emphasizing what is important in terms of shareholder value, as the principle that "a company belongs to its shareholders" gradually started spreading beyond Europe and North America.[2]

Many factors are behind this change, including the collapse of the so-called main bank system. Perhaps the most important is the growing influence of foreign investors, which reflects the advances of the borderless capital markets. Looking at trends in stock trading value and holding percentages, we see that the influence of foreign investors in the stock market has been growing markedly in recent years (Figures 1 and 2). Even companies that raise funds only domestically face urgent pressure to establish management systems that generate continuous profit expansion as demanded by foreign investors. The overall climate of the market is shifting towards the pursuit of far greater accountability to shareholders.

Accordingly, Japanese companies can no longer afford to ignore these structural changes, both in terms of the financial and capital markets in Japan and with respect to global market realities. As they are finding themselves under increasing pressure to improve their bottom lines, the establishment of a management system designed to increase stakeholder benefits is a critical issue for Japanese companies.

Table 1. ICGN and OECD Principles

OECD Principles	ICGN Global Corporate Governance Principles
Rights of shareholders	• Major organizational changes require the prior approval of shareholder meetings • Shareholders have the opportunity to exercise their voting rights • Timely disclosure of the result of resolutions • Adherence to one-share, one-vote standard • Institutional investors assume proxy responsibilities to exercise voting rights
Equitable treatment of shareholders	• One-share, one-vote • Protection of the rights of minority and foreign shareholders
Role of stakeholders	• Directors should build good and productive relationships with stakeholders and are responsible for providing accountability to shareholders.
Disclosure and transparency	• Timely and full disclosure of adequate information • Disclosure of shareholdings and the status of voting rights • Disclosure of information on directors • Disclosure of policies on director compensation (preferably, the exact compensation paid to individual directors) • Audits of annual closings by outside statutory auditors
Responsibilities of the board of directors	• Judgment of directors independent from management operation • Establishment of audit, compensation, and nominating committees as well as the nomination of outside directors

Notes: ICGN = International Corporate Governance Network; OECD = Organization of Economic Cooperation and Development.
Source: Prepared by NRI based on data from the California Public Employees Retirement System (CalPERS) Website.

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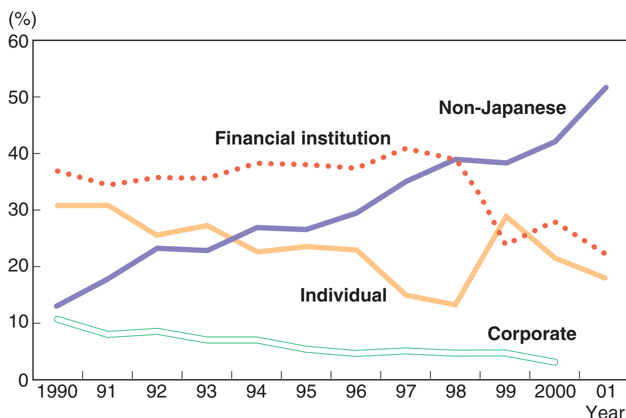
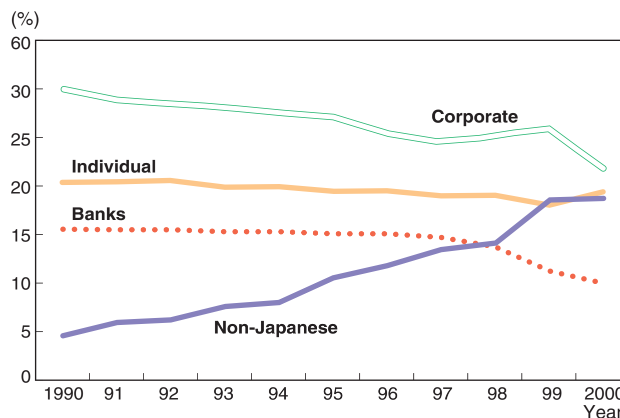
Figure 1. Trends in Stock Trading Value (According to Investor Type)



Notes: (1) The above represents purchases by proxy. Financial institutions denotes all life and non-life insurance companies, major and long-term credit banks, regional banks and trust banks; (2) Up to the second week of December 2001.
Source: Prepared by NRI based on the *Tokyo Stock Exchange Fact Book for 2001* and *Nihon Keizai Shimbun* data.

Figure 2. Trends in Holdings of Listed Stocks (According to Investor Type)



Source: Prepared by NRI based on the *Tokyo Stock Exchange Fact Book for 2001* and the Website of the Tokyo Stock Exchange.

Table 2. Examples of Reforms to Boards of Directors in Pioneering Companies

Date	Company	Detail
1997 May	Sony	Introduction of an executive officer system, reduction in the number of directors and the appointment of outside directors
1998 April	Tokyo Electron	Introduction of an executive officer system, Extension of the mandatory retirement age for outside directors
June	Fuji Photo Film	Introduction of an executive officer system, reduction in the number of directors
1999 March	Fuji Xerox	Establishment of a committee chaired by outside directors
June	Komatsu	Establishment of a compensation committee
June	TEIJIN	Introduction of an executive officer system, reduction in the number of directors Establishment of an advisory committee Strengthening the statutory audit committee

Source: Prepared by NRI based on press reports, etc.

2 Approaches by Japanese Corporate Pioneers

One example of a Japanese company taking the initiative in corporate governance reform designed to increase shareholder benefits was the introduction of the executive officer system by Sony in June 1997. This entailed reducing the number of directors (from 38 to 10), putting greater importance on outside directors by increasing the number to three out of ten, and differentiating between the board of directors and management committees. The result created an operational executive organization that was considered a rapid shift to the kind of corporate organization found in the United States. Subsequently, a steadily increasing number of companies began reforming their boards, introducing an executive officer system and appointing outside directors (see Table 2).

As many companies followed the example of these pioneering companies, such reforms became increasingly common. Moreover, this movement appears to have prompted amendments to the Commercial Code, which no longer reflected the prevailing reality. An examination of the trend since 1997 shows that corporate governance reforms aimed at increasing shareholder benefits have been progressing, gradually building a framework in companies that operate and raise funds globally.

3 Establishing a Legal Framework

Driven by the initiatives of the corporate pioneers, dramatic changes have been made in the Commercial Code regarding the composition and role of a corporate boards. In January 2002, the Legal System Investigation Commission completed a final draft of

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amendments that focused on the reform of corporate boards.

The core of this reform was to enable companies to choose between the existing system and the new system. The latter discontinued the usage of statutory auditors and introduced an executive officer system by establishing three committees—a nominating committee, a compensation committee, and an audit committee—that consisted mainly of outside directors.

Under the new system, the authority and responsibility of a position is clearly distinguished by a complete separation between the management supervisory organization (directors) and an operational executive organization (statutory officers). In addition, introducing outside directors with independent perspectives reinforced the monitoring and supervision functions. The statutory officers are now codified in law to clearly define the responsibility and the position of the existing executive officer system. This means that decision-making transparency has been enhanced from an external perspective, and critical matters that touch on the fundamentals of management are entrusted to parties outside the company.

With these amendments to the law, companies can no longer avoid making the effort to change their corporate governance on the pretext that the current legal system was not suited to the strict demands of the capital markets. Of course, the existing system still remains an option, and it is also possible to achieve a management that is more transparent and quicker to act within the framework of the existing system. Thus, adopting the new system is not mandatory. Regardless of which system is ultimately chosen, however, it will always be necessary in the future to provide accountability to the capital market.

How do most Japanese companies actually deal with these changes in corporate governance? This issue will be examined in the next section on the basis of responses to several surveys.

II Current Status and Issues Concerning Corporate Governance

1 Current Status and Issues Concerning Organizational Reforms in Decision-Making Systems

First, it is important to understand the characteristics of the decision-making system for corporate management in relation to corporate governance. Some companies have already introduced the new corporate governance system. This enables us to bring into focus the status and problems of organizational reform based on the results of several surveys that focus on outside directors and statutory officers. These positions will be specifically prescribed by the new legislation to emerge with the amendments to the Commercial Code in April 2002.

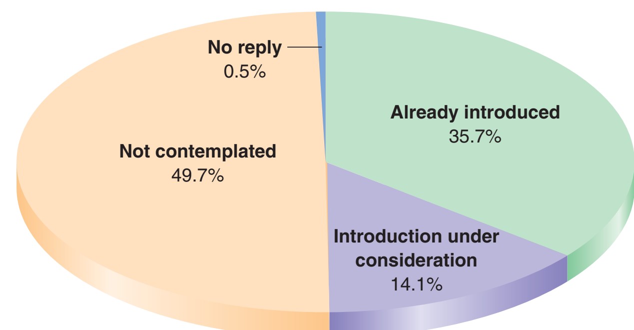
(1) Board reforms lead the Commercial Code amendments

According to a survey on board reforms conducted by the *Nihon Keizai Shimbun* in June 2001, 35.7 percent of the companies surveyed had already introduced an executive officer system, and 14.1 percent were studying its introduction. The total for these two groups was close to 50 percent (see Figure 3). Of the companies surveyed, 38.8 percent had already appointed outside directors, and 24.2 percent were reviewing such appointments (see Figure 4). Both the executive officer system and the outside director system are expected to be included in the amendments to the Commercial Code in 2002. However, the corporate sector has already started to act on these changes and has been proceeding to introduce these new formats since June 2001.

(2) Companies with new system reaching firmly adjusted stage

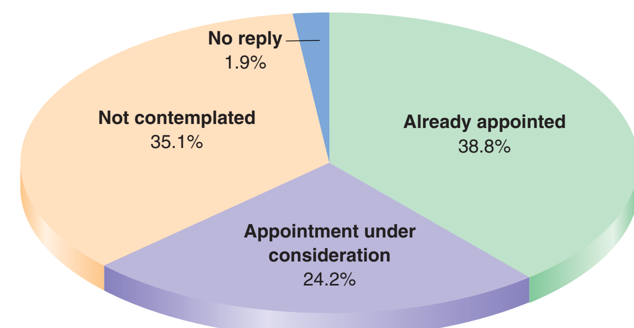
According to a Survey Concerning Information on Management Decision-Making conducted by NRI (Nomura Research Institute, Ltd.) in August 2001,[3] 32.7 percent of responding companies have introduced

Figure 3. Introduction of the Executive Officer System



Source: Prepared by NRI based on data from the June 16, 2001 edition of the *Nihon Keizai Shimbun.*

Figure 4. Conditions for Appointment of Outside Directors



Source: *Nihon Keizai Shimbun,* op. cit.

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the executive officer system, while 66.5 percent have not (see Figure 5). When a similar survey was carried out three years ago in 1998, only 13.0 percent of respondents had reported introducing the executive officer system.

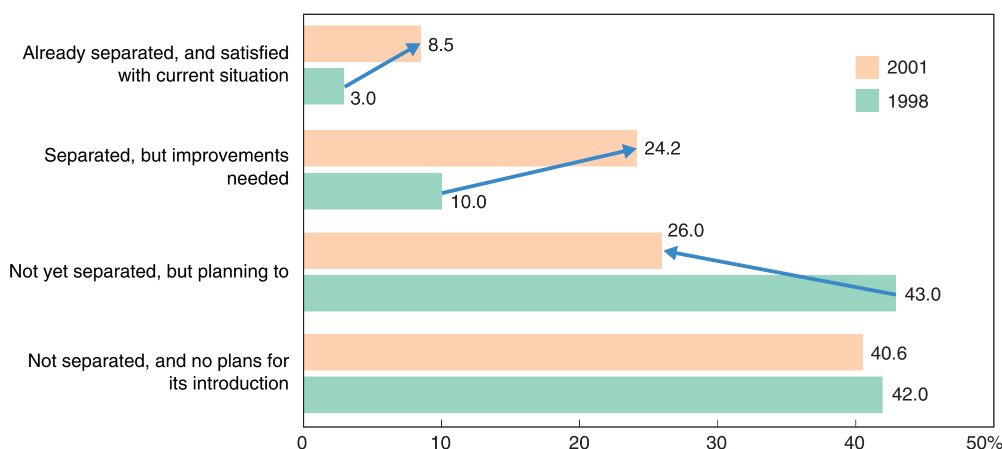
The percentage of companies that do not plan to introduce the system was almost identical in the two surveys cited above. Meanwhile, the percentage of companies that were studying its introduction has declined from the previous survey. This implies an increase in the number of companies that have firmly adjusted to the executive officer system since they have adopted the new governance system.

(3) Obstacles to the introduction of the new system: no clear internal definition

According to the survey conducted by the Corporate Law Division of the Tokyo Bar Association with the cooperation of the Commercial Law Center, Inc. in February 2000,[4] the "unclear definition of the legal status and standing" was the leading problem with the introduction of the executive officer system as well as an obstacle to its introduction (Table 3). This problem is expected to be resolved with the amendments to the Commercial Code in April 2002, based on the draft Law Concerning the Partial Amendment of the Commercial Code prepared in January 2002.

However, the second and third reasons for not introducing the executive officer system (i.e., "no clear definition of the roles of directors and executive officers" and "doubts as to the role of the executive officer") suggest that uncertainty about the role of an executive officer constitutes a substantial barrier to its introduction. It can be imagined how difficult it is for companies to effectively make use of the executive officer system without having a clear definition of the directors' roles.

Figure 5. Separation Between Management and Execution



Source: Prepared by NRI based on Survey Concerning Information on Management Decision-Making conducted by NRI in August 2001 and other data.

Table 3. Problems in Introducing Executive Officer System and Reasons for Non-Introduction (Multiple responses possible)

(Unit: %)

Questionnaire	Problems with introduction	Reasons for non-introduction
Resistance from directors	16.4	2.9
Not yet taken root in the industry	16.4	18.3
Unclear definition of legal status and standing	72.7	36.6
Unclear definition of role division between directors and executive officers	40.0	33.5
Meaningless as many executive officers concurrently serve as directors	18.2	18.1
Cannot reach internal and external agreement to reduce the number of directors	20.0	9.2
Adding unnecessary system	14.5	10.1
No clear authority to appoint an executive officer	12.7	4.6
Increase in costs due to executive officers	7.3	10.0
Inconvenience in external negotiations	5.5	3.4
Doubts as to the role of executive officer	–	24.1
No problem with current situation	–	12.0
Other	5.5	18.0

Source: Compiled by NRI from Corporate Law Division of the Tokyo Bar Association, ed., "Status of Executive Officers and Independent Directors," *Shoji Homu*, No. 243, Commercial Law Center, Inc., 2001.

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(4) Deep-rooted suspicions about the outside director system

According to the above survey, more than 60 percent of responding companies had already appointed or were considering the appointment of independent directors (see Figure 4). Meanwhile, there is strong opposition to requiring companies to appoint outside directors on the grounds that such appointments would restrict autonomous management.

In another survey conducted by the Tokyo Bar Association, companies cited the lack of appropriate candidates as a major reason for not appointing any outside directors. One should not infer from this that companies acknowledge the functionality of the system, however, as the other reasons for opposition mainly indicate that companies do not see the usefulness of the outside director system (see Table 4). It would appear that applying the outside director system will be difficult in companies that do not clearly understand the objectives and advantages of this system and have negative perceptions of it.

2 Difficulties in Tackling Corporate Governance Reforms

To understand what companies see as the actual problems they are facing—something that is difficult to discern from the above surveys, NRI is sponsoring information exchanges for companies that are tackling corporate governance reforms and also conducting individual interviews. Examples of these difficulties as revealed in the course of these meetings and interviews are shown below.

(1) Seeking a "next generation" model for family-owned companies

The search for next-generation corporate governance often becomes a subject of debate in family-owned companies. To cite one example of an electric equipment manufacturer, "We introduced an executive officer system three years ago to avoid the excessive concentration of authority in our founder's family and to win more autonomy for individual business divisions. As our company has shown good performance since then, we believe that the introduction of the system has been successful."

However, many companies noted that they have been trying to find the appropriate form for new corporate governance and methods of reforming the board of directors, which had become relatively weak while a strong founder was active in company management, once the founder reaches an advanced age.

(2) The need to change awareness and to redefine the roles of directors in *zaibatsu* groups

There is also a view that enlightenment is needed among companies that are part of the large commercial and industrial conglomerates of modern Japan known as *zaibatsu*, as their management lacks an appreciation of the importance of capital markets primarily due to the stable shareholding relationships they enjoyed in the past. In addition, there have been many calls for a change in management awareness. For example, critics claim that there are no competent directors with the ability to provide an overall business overview from the shareholder perspective, and directors are unable to relinquish the feeling that they represent an entire division.

(3) Problems with strengthening the statutory auditor system

Another option may be found in the statutory auditor system, which was revised by the 2001 amendments to the Commercial Code to require an increase in the number of statutory auditors and an extension of their terms of office. However, there are still problems that are yet to be addressed; namely, current statutory auditors have no right to dismiss a president, they cannot speak frankly because the president has the right to appoint statutory auditors, and appointments to the post of statutory auditor are regarded as a token of appreciation for service to the company. For these reasons, there is a shared opinion among companies that improving the framework of the statutory auditor system based on the law does not necessarily ensure legality or further progress in enhancing business efficiency.

(4) Seeking improvements in business management methods and processes

Companies trying to reform corporate governance have pointed out that merely changing the organizational structure is not sufficient, since real reform requires coordination with improvements in the methods and processes of business management. In fact, opinions such as, "The board of directors does not function effectively in the decision-making process," and "The quality and quantity of the information required for management and evaluation standards is not available" (as expressed by a precision machinery maker) would clearly suggest the reality that the system and

Table 4. Reasons for Not Appointing Outside Directors (Multiple responses possible)

(Unit: %)

Reason	Percentage
Doubts about system functionality	28.2
No appropriate candidates	37.5
Ensuring outside opinions through different methods	30.7
Satisfied with advice by outside statutory auditors	30.9
Extra effort required due to lack of business knowledge	18.6
Planning such appointments in the future	3.7
Other	6.3

Source: *Shoji Homu*, op cit.

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methodology required for business management falls short of what would be desirable. Indeed, many companies have pointed out the problem that, although the executive officer system and the independent director system were introduced for a certain purpose, other related systems have not been established to accomplish that objective.

III Responding to Demands with M³ Reforms

1 Improved Application System Essential to Establishing Corporate Governance

As the preceding discussion suggests, the outside director system and the executive officer system have been established to some extent at least with respect to the framework for corporate governance in Japanese companies. However, the original argument for introducing corporate governance arose from the understanding that corporate managers should change the management system to shift its focus to the rights and benefits of investors. From this perspective, corporate governance should not stop merely at preventing illegalities or enforcing compliance with laws and ordinances. Rather, the system of corporate governance should be built with the aim of improving the long-term business performance of a company to derive continuous profits not only for shareholders but also for other stakeholders. Establishing an ideal system of corporate governance requires not only the introduction of a framework but also an improved system of application that is adjusted to the practical situation.

Based on the results of the NRI survey of approaches adopted by certain pioneering companies, we have confirmed that reform from three perspectives is needed to realize an efficient application of corporate governance. This has become particularly clear in the course of examining companies with a corporate or holding company system that operates diverse businesses. NRI calls these three important objectives the M³ parameters: measurements, monitoring and motivation. We will explain each term in the following section.

We consider these M³ parameters to be the requisites for reform that are common to both groups of companies, namely those that chose the existing systems of a board of directors and statutory auditors, and those that chose to change to a system of outside directors and statutory officers in accordance with the amended Commercial Code. Apart from an awareness problem on the part of the chairmen and/or presidents, we consider the cause for non-functioning corporate governance in many Japanese companies to be the sharing (or overlapping) of roles among “directors,” with the M³ parameters not determined systematically or in a uniform way that enables an efficient sharing conductive to producing long-term benefits for stakeholders.

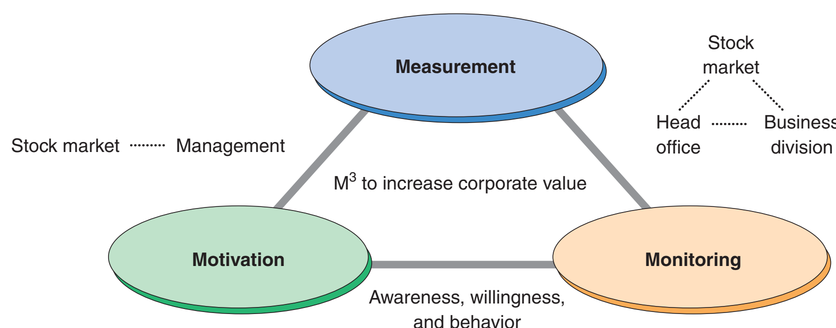
The discussion below will refer to the following three parties as directors, unless otherwise noted.

(1) Director: A person who supervises decisions on and the execution of a company’s overall management strategy (in the latter sense, including the existing statutory auditor), and who does not concurrently serve as an executive officer as set forth in the second definition below.
(2) Executive officer: A person who makes decisions and carries out operations to implement such decisions, including an existing president, executive director, manager, or (general) manager of a division.
(3) Management: General term for inside and outside directors and executive officers, as defined by the first and second definitions above.

2 Reforming the Application System from Three Perspectives

(1) Measurements: business performance indices
There is an upward trend in the number of companies that have publicly announced the introduction of indices reflecting capital costs, as represented by

Figure 6. M³ Parameters that Enable Corporate Governance to Function



Source: Nomura Research Institute.

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Economic Value Added (EVA), instead of employing accounting profits as used in the past to measure business performance. This tendency itself should be positively appraised. However, there are cases in which a mismatch occurs in internal business management.

One of the reasons for this is the lack of consistency between the subject of business performance indices and their purposes. There is a difference in the policy of business performance between directors, who should focus on value creation from a shareholder perspective, and executive officers in charge of business operations. It is necessary to clarify these roles and the business performance indices based on the respective characteristics of each.

Another reason is that the key criterion for a decision to pull out of a business has not been adequately clarified. An application example of an established criterion for such a decision is the "EXIT rule" established by Mitsubishi Corporation, which decided that quantitative criteria consisting of internal ratings and its own version of EVA would constitute the rules in determining whether or not to pull out of a business in which it held a vested interest. If such clearly quantified criteria are not employed, it is difficult to assert that corporate governance is functioning effectively.

(2) Monitoring: supervision of management

From a monitoring point of view, it is necessary to improve accountability to investors by accepting external perspectives. This requires improvements in the quantity and quality of the information used for management decisions, while at the same time building substantially transparent and prompt decision-making processes. Explicitly, it is necessary to introduce to the board a mechanism of management supervision that will win market approval, while the board acts as agents of investors when making decisions.

In this respect, NTT has developed a mechanism for investment management to enable closer monitoring of the companies it has invested in. NTT determined a cycle of supervision that depended on business performance and the strategic objective of financial indices as the criteria for supervision, and executes decisions on additional investment, reconsideration and withdrawal based on a comparison of forecasts and results. With this decision-making mechanism, management transparency can be ensured, and the quality of management judgment improved.

(3) Motivation: providing incentives for management

To motivate management, reforms to remunerate management (directors and executive officers) based on fair performance measurements are essential. In the past, management compensation centered on fixed salaries, often lacked long-term incentives and did not provide transparency in the evaluation process. Hence, the objectivity needed to motivate managers to continuously improve shareholder value did not exist.

Toshiba is an example of one company that has tackled this issue. The company decides what portion of the annual executive salaries will constitute a performance-based salary bonus that is linked to the achievements of the respective position and division. This performance-based salary bonus fluctuates depending on consolidated net sales and the extent to which Toshiba's original EVA has been achieved. It is therefore appropriate for corporate managements to increase the percentage of the annual salary that is linked to shareholder value, such as performance-linked bonuses or stock options (the right to purchase shares in one's own company).

IV Establishing an Application System for Corporate Governance Through M³ Reforms

The following methods are considered specific approaches to successfully reforming the M³ parameters. These methods will be effective when their interrelationship is mutually consistent.

1 Organizing Information for Judging Performance Depending on the Level of Decision-Making and Management

This is an approach that is designed to improve decision-making for the entire company by clarifying the basis and purpose of management.

(1) Risk return management

In the past, return analyses were most often based on indices such as net present value (NPV), return on investment (ROI), and internal rate of return (IRR) when investing in a business or company. In most cases, however, it was an analysis based on a single scenario, and relatively few cases actually involved risk analyses. Even if a risk analysis were carried out, it tended to remain an optimistic and persuasive presentation design for the purpose of getting a draft proposal approved. In addition, the risk discount rate was no more than a hurdle rate (cutback rate) for evaluating ROI, and in most cases did function as a damper on overly optimistic forecasts. Armed with such limited information, the board of directors is not able to make adequate decisions. As a consequence, there are many examples of stockholders being forced to foot the bill for actions taken as a result of overly optimistic outlooks.

Hence, it is necessary to forecast earnings for individual business units (divisions or important

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investment and financial projects) by quantifying the downside risk (assuming the worst-case scenario). For that purpose, risk information should be submitted at the time a proposal is drafted. Based on this, the risk return of each business unit should be clarified and objectively understood by creating a diagram or other visualizing tool. The board of directors can thus judge and adequately determine the relative merits of reorganizing, integrating or discontinuing business units and re-allocating resources from a risk-return perspective for the entire company (much as would be the case in managing a portfolio).

Meanwhile, as long as executive officers achieve the required performance based on the allocation of resources as determined by the board of directors, the board should be particularly careful when intervening in the fundamentals of management indices that executive officers use for ordinary operational decisions. This is because creating superfluous committees and watering down the responsibilities of executive officers through increased director interference in business divisions tends to obscure the responsibility and authority of both parties.

(2) Manual for business investments, financing and withdrawals

Decisions on investments, financing or withdrawals concerning a business or business unit are often delayed because of issues concerning past history, responsibility, and the intentions of the office or person in charge. To prevent this situation, quantified rules and manuals should be prepared and clarified.

A leading service company has produced a manual of criteria for investment management. Among other things, it clarifies the indices to be used by the head office in monitoring each division, as well as the extent of the delegated authority at various stages of the management process, while still providing support for decision-making by directors.

2 Developing Software and Hardware for Business Monitoring

In terms of monitoring and supervision, a key question is whether a monitoring system has been put in place to improve business performance through the proper functioning of the management cycle of the entire company. Specifically, this means a Plan, Do, and See cycle for decision-making and management execution.

(1) Reorganizing a company's hypotheses and verification cycle (developing hardware)

The regular internal meetings that take place at present, including divisional meetings on business performance or the board of directors, may have become a venue where excuses for unsatisfactory achievement are presented or where failure is reprimanded. After providing a forum for sharing experiences based on verification and lessons from past business performance, committees can be made to function effectively as a way of participating in management through declaring the objectives and plans for the future term. It is then necessary to design and plan the functions and timing for multiple committees as a vehicle for drafting proposals, granting approvals, reporting and verifying, without redundancy and in a consistent manner. At the same time, lower echelon committees need to be held accountable to higher ranked committees. The cycle of internal hypotheses and verification will be reinforced if the forum for investor relations is used as a summit to extend the cycle to be externally evaluated at the end of the series of committee meetings.

Meanwhile, a small number of senior directors participating in a meeting of managing directors or management committees have been responsible for important strategic decision-making and subsequent management, and in most cases the monthly board meetings remained a venue for ratifying the resolutions of these small meetings. In the future, however, the board will be in charge of strategic management decisions and the supervision of executive officer operations. Similarly, executive officers will focus on decision-making or the subsequent execution of their responsibilities, and a mechanism to facilitate communications between both parties will become more significant as a result of their different roles and responsibilities.

With respect to the strategy issue, one measure would be to adopt a balanced scorecard approach, which links important indicators such as financial indicators including the enhancement of shareholder value with customer perspectives, internal business processes, and employee learning and growth.

(2) Measures to improve governance literacy (developing software)

Management will not be equipped with the skills and competence to make the best decisions simply by modifying the information on management decision-making, employing appropriate business performance indices, and reorganizing committee mechanisms. In order for corporate governance to function as described in this paper, management needs to improve its ability to apply it. This is what is known as "governance literacy."

To enhance management's awareness of the role of corporate governance, it is essential to provide both the opportunities and the format to cultivate management. Concurrently, to transform role perception from one of divisional representative to management, it is necessary to change the roles of directors and executive officers as well as to define the requirements for the

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appointment of directors based on their competencies (the mindset and behavioral characteristics of those who are qualified).

In terms of human resource development, there is a method for creating a system to strategically build a career path in personnel administration. Sanyo Electric's approach to train management candidates is to handpick promising young staff members for a mandatory career path that goes from strategy planner at an affiliated company all the way to the post of CEO. Furthermore, the standard for nominating the director or executive officer is set to evaluate candidates based on quantitative as well as qualitative factors, such as personality, intelligence, competence and track record. Thus, Sanyo Electric strategically links the development of management to personnel administration by bringing the recommendations of director candidates into perspective in the nominating committee.

These skills and competencies can find practical application only by acquiring them through hands-on experience rather than simply through theoretical knowledge. For that purpose, we could modify the following old methods to a program that serves to enhance governance literacy, if it is well devised. The old methods are an "internal venture" where an employee who is provided with capital and authority in personnel affairs starts up a new business and is required to get the business into the black within a certain period to experience a virtual CEO post or a "private school for future presidents," where the young candidates for executive positions gather to learn theory.

3 Strengthening Management Incentives to Increase Corporate Value

This is an approach to give management (directors and executive officers) the incentive to make decisions and execute operations in a way that improves corporate business performance and shareholder value over the medium to long term. This can be achieved by providing them with a compensation package that is linked to increase the corporate value.

By aligning the interests of management with corporate business performance and investor benefit, management will have stronger incentives to make decisions and execute operations in a way that creates medium to long term corporate value. To create greater incentives, the share of total compensation that is linked to business performance and corporate value (e.g., bonuses linked to financial performance, stock options, and retirement allowances based on financial performance during the tenure of office, etc.) should be raised, and a system established to ensure transparency and objectivity in compensation decisions (Who decides and how?).

In accordance with the amendments to the Commercial Code, the old system of stock options that could be granted only to directors and employees will become a *shinkabu-yoyaku-ken* (right to acquire new shares) that can be broadly applied. This enables the directors and employees of subsidiaries and affiliates to be granted subscription rights, thereby making more choices available in terms of incentives to motivate the management of affiliates to pursue effective decision-making and operational execution that will increase the gross value of affiliated companies over the medium to long term.

V Quality of Corporate Governance Comes into Focus

The debate over corporate governance tends to focus on the competing perspectives of those who stress the importance of employees and those who emphasizes the rights of shareholders, between the Japanese and the US models, or between the old system (strengthening the position of statutory auditors) and the new system (establishing a system of executive officers, outside directors and management committees). However, none of these arguments is necessarily essential or constructive. With the legislative preparations for amending the Commercial Code, more options could be available to companies. Every company must establish its own M^3 application system as described above, so that its board of directors can break free of the habit of merely following the crowd and proactively proceed towards practical corporate governance reforms on its own accord.

We are no longer in the phase where forming an organization is based merely on laws and systems and in concert with what others do. Instead, we have now reached a new stage of establishing a practical application system, which will yield greater divergence in business performance. Improving the quality of corporate governance should be the first issue to be settled by management.

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(1) ICGN was established in 1995 with the objective of facilitating the international exchange of information on corporate governance among investors and achieving a common understanding among companies and institutional investors across borders.

(2) Among other factors, stressing the importance of employees still runs deep among management in Japan. But as seen in the results of research which concluded that "Japanese-style corporate governance that is formed and maintained based on the negotiating strength of employees has a serious disadvantage because it neglects shareholder value" (Takafumi Sasaki and Yasuhiro Yonezawa, "Corporate Governance and Shareholder Value," *Journal of*

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Securities Analysts, September 2000), there is a widespread trend towards substantially modifying traditional Japanese-style management.

(3) The companies surveyed are based in the Tokyo, Chukyo or Kansai areas and listed in the First Section of the Tokyo Stock Exchange or the Osaka Securities Exchange. The number of sampled companies was 1,562, respondents totaled 304 (a response rate of 19.5 percent), and the number of valid responses was 281 (17.9 percent).

(4) While these data are somewhat old, we used the figures as we concluded that most of the objectives, rationale and problems associated with the introduction (or non-introduction) of corporate governance systems remain the same even today.

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