

# International Comparison of Corporate Governance

Internal mechanisms of CG: the  
boards of directors

基礎企業ガバナンス論

2 December 2011

# Overview of studied material

- The outsider (Anglo-Saxon) model: dispersed company ownership, the shareholders are “outsiders” who invest for short-term financial gain
- The (agency) problem: shareholders are not able to monitor and control the managers
- The proposed solution: harmonize manager incentives with the incentives of shareholders via the so-called “equity-based compensation” (shares and stock options)
- But the solution itself became a problem (as seen from the failures of Enron and Lehman Brothers)

# How could managers be controlled?

## I. Internal mechanisms

- The annual general meeting (AGM) of shareholders, the board of directors (BoD)

株主総会、取締役会

## II. External mechanisms

- The threat of hostile takeover, shareholder lawsuits, government regulations, codes of best practices

敵対的買収、株主訴訟、政府の規制（会社法や証券法）、最善行動規範（コーポレート・ガバナンス規則）

# The internal mechanisms

- The AGM elects and removes the members of the BoD, and the BoD hires and fires the top managers (e.g. the CEO, the CFO, etc.)
- Power of the AGM > power of the BoD > power of the top management ?
- But in fact, the role of the AGM is often reduced to the formal approval of the board members proposed by the CEO

株主総会の形骸化

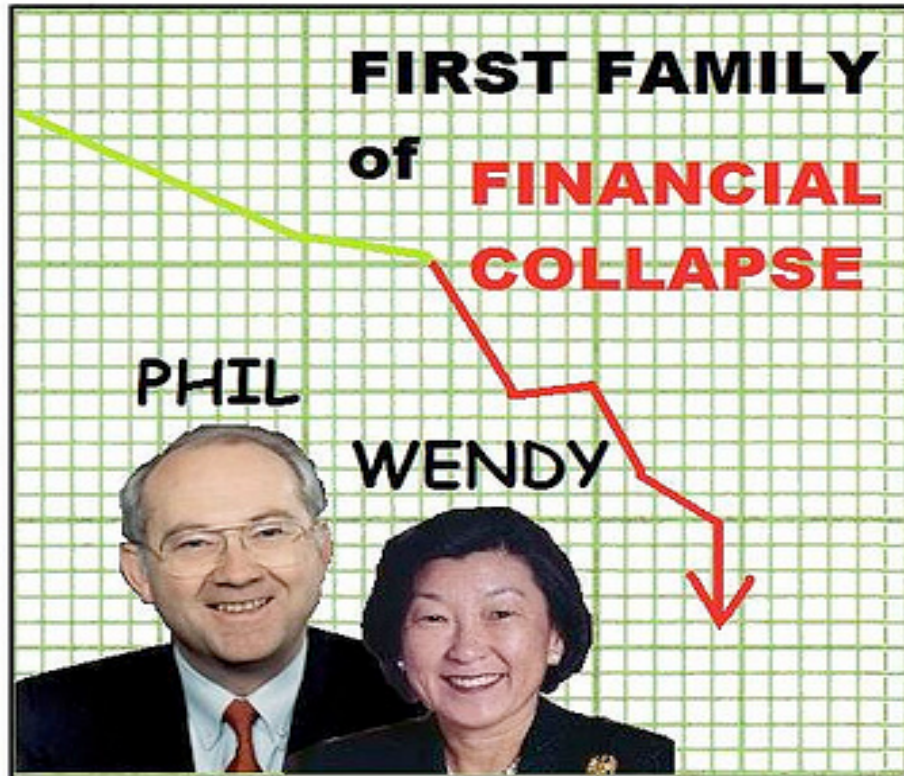
- The board members proposed by the CEO are often unable to confront him/her because of conflicts of interest

利益相反

# Conflict of interest

- “a situation in which someone in a position of trust, such as a politician, government official, executive or director of a corporation, has competing professional or personal interests ... such competing interests can make it difficult to fulfill his/her duties impartially”
- **Examples of conflicts of interest**
- **Some members of Enron’s Board of Directors worked for companies or NGOs that benefited directly from business or financial contributions by Enron**
- **Others benefited indirectly: Wendy Gramm was a member of Enron’s audit committee and the wife of a Texas senator (Phil Gramm) who received financial contributions from Enron**

“Number 2 person responsible for the 2007-2008 US subprime crisis”



**UBS**

# Board duties

- (1) “Duty of loyalty”: the directors must be loyal to the company’s shareholders
- (2) “Duty of care”: the directors must find as much information as possible and consider all reasonable alternatives before making decisions

The board should also:

- hire the top management
- determine managers’ pay
- evaluate regularly their performance
- replace them if the company’s performance is not satisfactory

# Board size and composition

- Size: from 5 to 25 directors
- Composition: Chairman, executive and non-executive directors  
取締役会会長、社内取締役、社外取締役
- **The Chairman and the CEO can be the same person or different persons**  
同じ人物が会長と最高経営責任者を兼任するケース、会長は最高経営責任者とは異なる人物であるケース
- The executive directors work full time in the company, while the non-executive ones come from outside

# Board types I

## I. Unitary or single-tier boards (US, UK)

### 単層制取締役会

- The CEO is usually selected from outside the company (there is a market for top managers)
- The CEO is a member of the board and often combines the role of the Chairman
- There is a majority of non-executive directors
- There are no representatives of employees
- The pay of the directors is much higher than that of their peers in Continental Europe and Japan (a larger part of the directors' pay is in shares and stock options)

# Board types II

## II. Dual or two-tier boards (Continental European countries like Germany, Austria, the Netherlands)

### 二層制取締役会

- **Supervisory board (SB) and management board (MB) 監査役会、執行役会**
- The CEO and the Chairman are often members of the controlling family and people promoted from inside the company
- The CEO is not a member of the SB; he/she and the Chairman are different people
- The SB is fully composed of non-executive directors
- There are representatives of employees in the SB

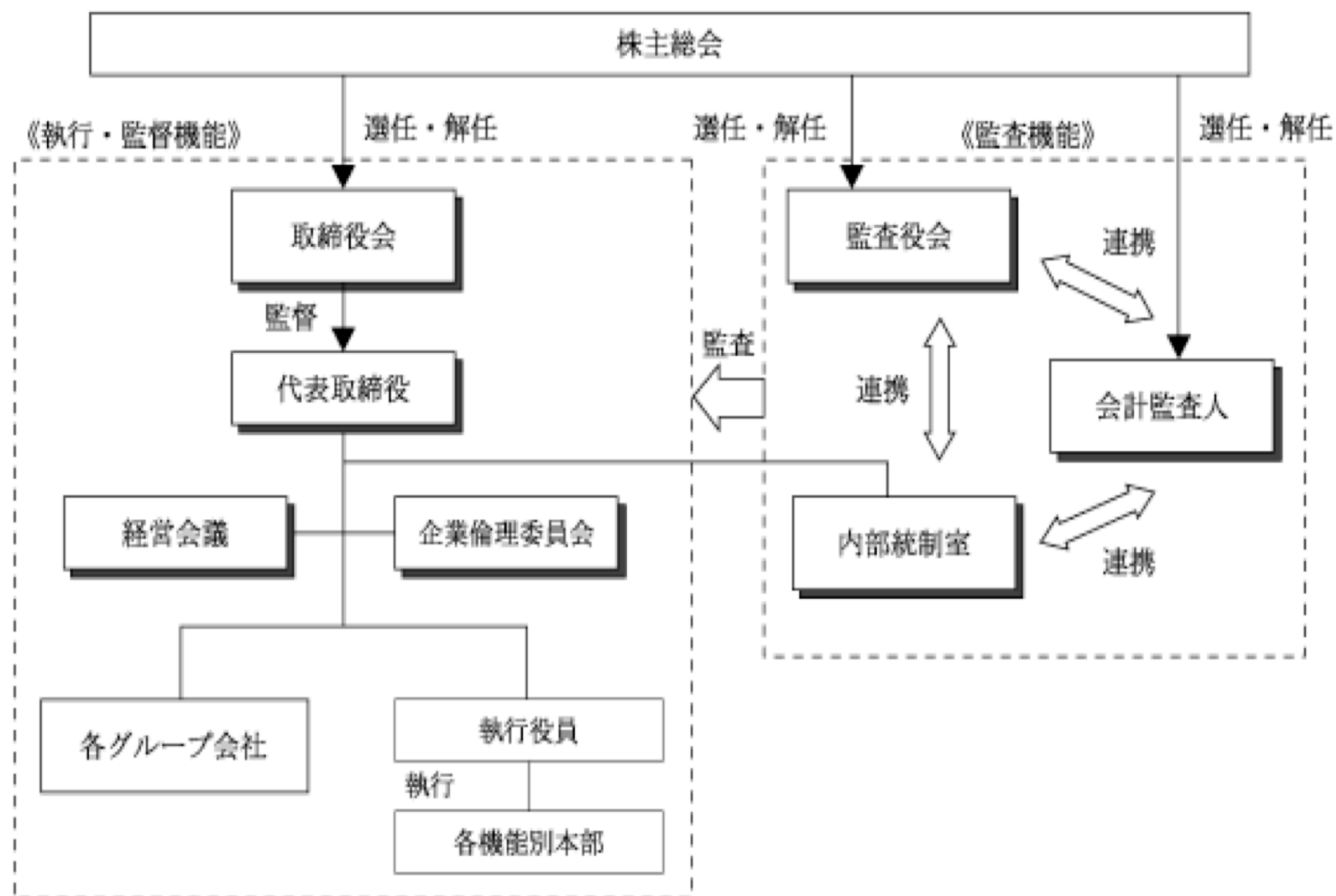
# Board types in Japan

## I. “Companies having an auditor board”

### 監査役会会社

- The board structure looks similar to the two-tier type (the auditor board = supervisory board ?)
- In fact, it is different because the auditor board 監査役会 is very weak and ineffective
- For example, the auditor board cannot hire and fire the managers like the SB in Germany; the auditors are not independent from the managers

# The classical Japanese board I



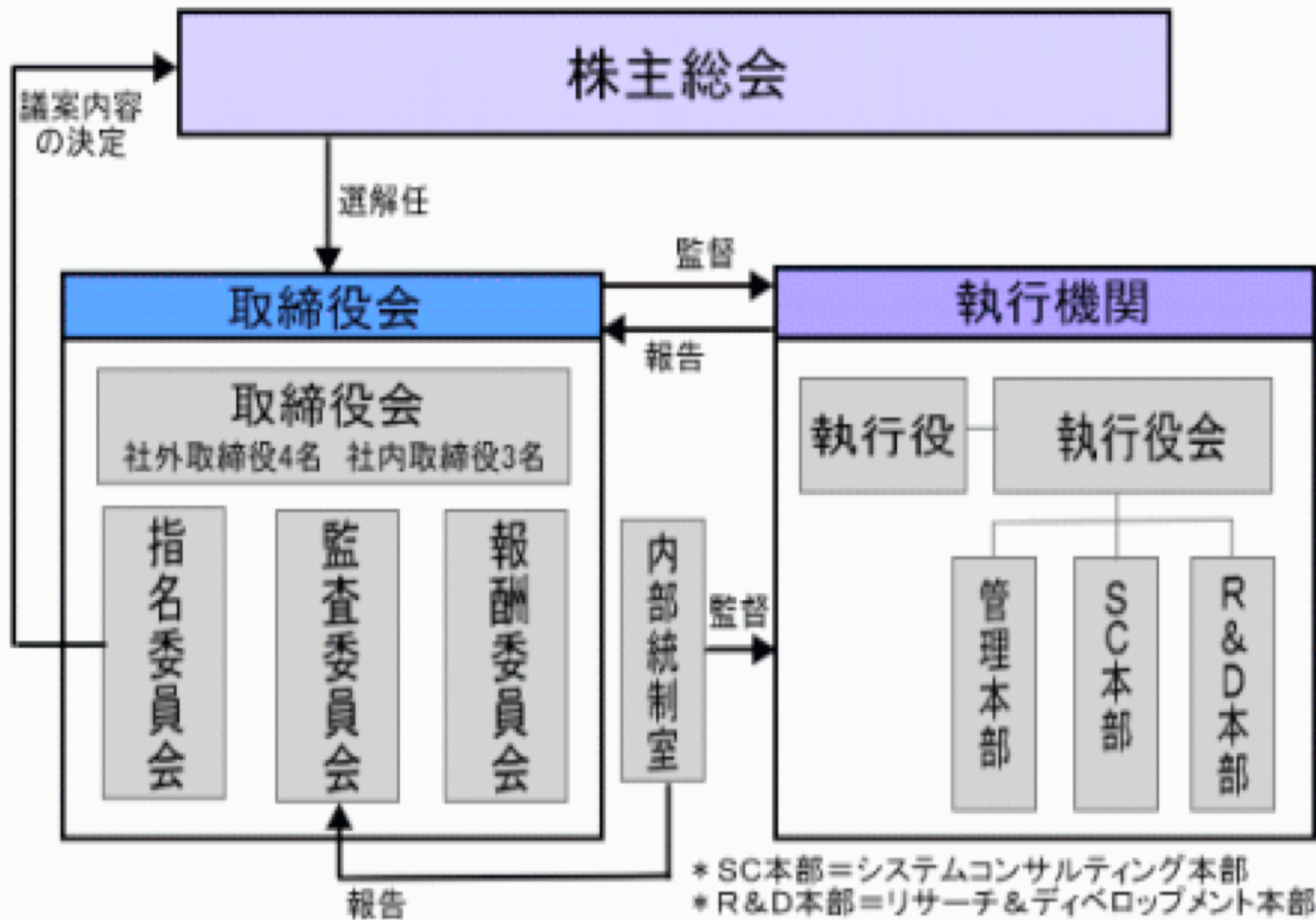
# The classical Japanese board II

- The top managers usually come from within the company 社内昇進、生え抜き
- The board 取締役会 is almost fully composed of executive directors
- If there are any non-executive directors, they are also “insiders” (for example, people from other companies or financial institutions from the same business group)
- We should distinguish between non-executive 社外取締役 and independent directors 独立取締役
- Criteria for director independence (discussed later)

# Board types in Japan

## II. “Companies having a committee system”

委員会設置会社



# The committee system in Japan

- Separation (like in the two-tier board type) of the supervising function of the board from the management

取締役（監督機能） → 執行役

- There is a majority of non-executive directors in the BoD
- There are nomination, audit and remuneration committees on the board where the non-executive directors should be in majority

# Why do boards fail? I

**(1) The directors lack independence from the management or the controlling shareholder of the company**

- Example #1: the directors are either relatives, personal friends or business partners/associates of the managers (or the controlling shareholder)
- Example #2: the managers or the controlling shareholder are also members of the boards of the companies from where the directors come (“interlocking directorates”)

# Definition of director independence

According to the European Commission

**“A director should be considered to be independent only if he/she is free of any business, family or other relationship with the company, its controlling shareholder or the management, that creates a conflict of interest such as to impair his judgment“**

**Pls. see also the next slide!**

# Criteria of director independence

## A director is considered independent if he/she:

- Does not financially or otherwise depend on the company's management or the controlling shareholder
- Does not financially or otherwise depend on the management or the controlling shareholders of affiliated companies
- Is not a representative of the government or any consultants contracted by the company
- Has disclosed his/her personal (or his/her relatives') transactions with the company's shares or other financial instruments

# Why do boards fail? II

**(2) The directors either lack sufficient information about the company or are short of the expertise necessary to decide on some complex technical matters**

- Example: the directors may not have expert knowledge in accounting or the use of complex financial instruments like derivatives

**(3) The directors have excessive commitments**

- Example: the directors are not only super busy with the running of their own companies but also they often serve on a large number of other companies' boards

# CG problems in the investment banks before the present crisis

The boards of the investment banks could not exercise proper oversight over the management due to:

- (1) Generous remuneration packages leading to conflicts of interest (i.e. getting paid millions of dollars per year for just attending several meetings)
- (2) Lack of sufficient information as executives controlled the information flows
  - This was especially pronounced at the banks where the roles of Chairman and CEO were combined
- (3) Shortage of industry expertise and financial literacy
  - The directors did not have financial services industry experience
- (4) Absence of risk-assessment mechanisms on the boards

# Questions for discussion

- (1) Pros and cons of “having more independent directors on company boards” (is it better to have 100% independent directors?)
- (2) Pros and cons of employee representation on company boards (should Japan also introduce this system?)
- (3) Pros and cons of quotas for the number of women on company boards (what are the advantages of having women? just “prettier and more colorful”, or something else?)