Corporate Governance and the Rule of *Soft* Law [1]

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I. Introduction

On September 7, 2012, the Legislative Council of the Ministry of Justice ("Legislative Council") adopted the Draft Revision of the Companies Act 2005 ("Draft Revision"), which intends to enhance the regulation on corporate governance and corporate groups in Japan. The Legislative Council is a consultative body of the Minister of Justice, and government-sponsored bills to revise Companies Law are always based on its Draft Revisions. Among other proposals, the Draft includes a new disclosure requirement, which is as follows: "A listed company that does not have an outside director as a board member shall, in its business report, explain the reason why it is not appropriate for the company to have one."

On the same date, the Legislative Council also adopted the Resolution with the Revision of Companies Act ("Resolution"), which refers to the following request to stock exchanges: "In addition to the requirements stated in the Draft Revision of the Companies Act, stock exchanges shall, taking into account all relevant discussions and the current status of the adoption of outside directors, provide a rule with respect to the regulation on outside directors with specific regard to listed companies seeking to hire one or more independent directors as the response at this stage."[2]

The Legislative Council in its Draft Revision and Resolution introduced an approach called "comply or explain" in order to regulate the board structure of listed companies, which is the central theme in the field of corporate governance reform. It is a "soft" approach in the sense that (1) the proposed Draft does not impose a specific governance structure, but it allows the deviation as far as each company gives an "explanation," and (2) the details of the regulation are not given by the state but by stock exchanges, and the rules are not necessarily enforced by states. Of course, the "soft" approach is not a completely new idea. The most famous example in the area of corporate governance is the "Corporate Governance Code" implemented by London Stock Exchange in the United Kingdom.

Why did the Legislative Council adopt the "comply or explain" approach in this recent revision? One might say that it is simply a product of political compromise because the mem-

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2 Note to Part 1, Section 1-2.

bers of the Council could not reach a consensus. Some are strongly in favor of introducing outside or independent directors to the boards of Japanese firms, but others are strongly against this measure. Although this explanation contains some truth, it does not provide the whole story. The adoption of the “comply or explain” approach has a more profound background. This paper explores the theoretical basis of the approach and examines its limit.

Three basic questions should be answered when legislators wish to address the issue of company board structure (or corporate governance structure in general): (1) Does the board structure (or corporate governance structure) matter?; (2) Is there an optimal board structure?; (3) How can the legislator enforce the board structure that he or she wishes to achieve?

Legislators in every country always answer the first question in the affirmative when they propose corporate governance reforms. Despite the responses of legislators in many countries, traditional studies have responded in the negative to this question.

Part II focuses on studies about whether changes in board structure, such as size and composition, could affect the firm’s value. Part III reviews recent studies on econometrics and draws implications from their findings. Contrary to traditional studies, these recent studies assume that board structure *does* matter, and seek to answer the second question (“Is there an optimal board structure?”). They are based on the model that a desirable board structure may differ from firm to firm; hence, there may be no single “optimal” structure. Part IV reviews empirical studies on the determinants of board structure. They show that voluntary choices by firms can lead to efficient board structures in some countries, but not in others. Finally, we examine the third question: How can the legislator enforce the board structure that he or she wishes to achieve? Part V re-examines the advantages and disadvantages of the “soft” approach in this context. Part VI presents the conclusion.

II. Does the Board Structure Matter?

The first question is whether the board structure matters. One might assume that the answer is self-evident because it is always the premise of corporate governance reform in every country that a better board structure (or corporate governance structure) leads towards the improved performance of firms. Otherwise, any intervention in the board structure is just a waste of resources. Nevertheless, traditionally the econometrics literature has challenged this intuition and argued that board structure *does not* matter. Although many attempts have been made in order to find a correlation between a firm’s board structure and its performance, few studies have found a correlation between a firm’s performance and the size or composition of its board.[3] Therefore, it has been argued that board structure (either size or composition) is irrelevant to firm value. In opinion of several previous researchers, the legislators of many countries have been acting according to a belief that has no empirical foundation.

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3 *See* generally, Sanjai Bhagat and Bernard Black, The Non-Correlation Between Board Independence and Long-Term Firm Performance, Journal of Corporation Law, Vol. 27, pp. 231-273 (2002).

III. Is There An Optimal Board Structure?

Recent empirical studies have argued that the board structure *does matter* despite the lack of correlation between board structure and firm performance. The essence of their argument is as follows.

Traditional studies focused on the correlation between the board structure of firms in general and their performance. Under this methodology, a positive correlation can be found between the number of independent directors (or the board size) and the firm's performance if a greater number of independent directors leads to better performance. However, it is more plausible that each firm has its own optimal board structure and own optimal number of independent directors. The firm's best performance would then be achieved with its optimal number of independent directors. If the firm either increases or decreases the number of the directors, its performance would decline. For instance, let us assume that the optimal number of independent directors is five of seven board members for a particular firm. The firm's performance would improve with an increase in the number of independent directors until it reached five. Then the firm's performance would then decrease with the increase in independent directors after it reached five.

Under this model, one cannot find the correlation between a firm's board structure and its performance because the optimal number differs from company to company. However, this *does not* mean that board size or board composition does not matter. On the contrary, the firm's performance would be best achieved with the optimal board size and composition; therefore, it is important that each firm choose the size and composition of its board.

Traditional empirical studies asked whether there was a general correlation between board structure and firm performance. However, this question makes little sense. It is more important to ask whether each firm adopts its own best structure and what type of company needs what type of board structure (e.g., a bigger [or smaller] size of board or more [or less] independent board members, etc.). Indeed, the recent empirical literature no longer examines the correlation between board structure and firm performance. Instead, these studies examine the determinants of board size or board composition, and their findings show a correlation between type of firm and type of board structure.[4]

According to the recent literature, the answer to the question of whether there is an optimal board structure is as follows: Although board structure does matter for firm performance, no board structure is optimal for all firms. In other words, there is no "optimal" structure as such.

4 *See*, for example, Jeffrey L.Coles, Naveen D. Daniel, and Lalitha Naveen, Boards: Does One Size Fit All, Journal of Financial Economics, vol. 87, pp. 329-356 (2008); James S. Linck, Jeffry M. Netter and Tina Yang, The Determinants of Board Structure, Journal of Financial Economics, vol. 87, pp. 308-328 (2008); Kenneth Lehn, Sukesh Patro and Mengxin Zhao, Determinants of the Size and Structure of Corporate Boards: 1935-2000, Financial Management , vol. 38,pp. 747-780 (2009).

IV. How Do Firms Choose their Board Structure in the Real World?

Empirical studies on the determinants of board size or board composition support the hypothesis that US firms, on average, choose their optimal board structure.[5] First, they select several factors that might affect the optimal board structure. For instance, one can easily imagine that more diversified firms with more branches need more directors with different kinds of expertise. One can also predict that firms that need special knowledge and skills require a greater number of inside directors. They then examine whether the data support these predictions. The literature shows that the actual choices of the firms in the US are more or less consistent with the results predicted by the models. In short, firms in the US generally seem to choose their optimal board structure. If this is the case, the law does not have to intervene in the firm's board structure. Indeed, any intervention would not be necessary or, even worse, could decrease the firm's value. In fact, one study showed that the Sarbanes and Oxley Act, which requires board independence, caused inefficient results.[6]

Researchers conducted essentially the same analysis on Japanese firms listed on stock exchanges. Curiously, they found the opposite result: firms that needed a larger number of independent directors hired fewer and vice versa.[7] In short, the choices made by Japanese companies seem inefficient. The researchers conclude that the market force does not effectively lead Japanese companies to achieve an optimal board structure because management can successfully affect companies' choices to favor its interests. If this is the case, it may be possible that intervention by the state achieves better results.

V. How Should the Legislator Intervene with the Board Structure?

As is indicated in Part IV, Japanese firms may not voluntarily choose an optimal board, and state intervention might improve the situation. How then should legislators implement the regulation? It is not advisable to set a minimum number or percentage of independent directors that is applicable to all firms. This is inconsistent with the basic premise on which the recent literature rests: the board structure matters, but the optimal structure differs from firm to firm. Thus, a "One-size-fits-all" type of regulation should be avoided. The "soft" approach adopted by the Legislative Council can be best understood as the response to this problem. Although the approach shows the legislator's recommendation for each firm's board structure, it allows firms to deviate if they give an explanation. Some empirical studies have concluded that the "comply or explain" approach to corporate governance regulation has worked well in the United Kingdom since the 1990s.[8]

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5 See, the literatures cited in *supra* note 4.

6 Sanjai Bhagat and Brian J. Bolton, Sarbanes-Oxley, Governance and Performance (March 17, 2009), available at SSRN: http://ssrn.com/abstract=1361815 or http://dx.doi.org/10.2139/ssrn.1361815.

7 *See* Takuji Saito, "Determinants of Board Composition when Managers Control Director Selection: Evidence from Japan"(2011) (unpublished manuscript), Konari Uchida, Determinatnes of the Ratio of Outside Directors and Firm's Performance, Securities Analysts Journal, vol. 50, no. 5, pp. 8-18 (2012) [in Japanese].

8 Sridhar Arcot, Valentina Bruno and Antoine Faure-Grimaud, Corporate Governance in the UK: Is the Comply or Explain Approach Working?, International Review of Law and Economics 30 (2010), pp. 193–

However, the approach is inherently weak. First, for the approach to work properly, each firm should have the incentive to give a meaningful explanation to both investors and the market when it deviates from the rules provided by the legislator. The market should also respond properly to the explanations given by the deviating firms. Unfortunately, an empirical study on firms listed on the London Stock Exchange, which adopted the "comply or explain" approach for corporate governance, shows it may not be the case.[9] First, the study found that the overwhelming majority of firms choose "comply" rather than "explain." Second, the minority of firms that choose "not to comply" often do not offer meaningful explanations. Finally, the minority of firms that choose "not to comply" are usually highly profitable.

These facts suggest that it is too costly for firms to make persuasive explanations for non-compliance, so they often choose "comply" even when the deviation is desirable. Firms can safely choose "not to comply" only when they are highly profitable because investors or the market would not complain about these firms even if they give insufficient explanations. If this is the case, the "comply or explain" approach does not work as is supposed to do. The resulting "over-compliance" would lead inefficient outcome.

The influence of institutional investors might aggravate the situation even further. The fund managers of institutional investors are accountable to their own investors. Because it is costly for the institutional investor's fund manager to "explain" to their own investors why they support firms that choose "not to complain," they may tend to vote against the firm's decision and turn a deaf ear to its "explanation" even if they understand that the best choice for the firm is "not to comply." If this happens, each firm would have a strong incentive to "comply" regardless of the desirability of such a choice.

Second, a collective response by the industry group might completely undermine the "comply or explain" approach. This is an immediate concern regarding the current revision. It is reported that the Japan Business Federation (*Keidanren*) is now drafting a "standard explanation form" available for firms that do not adopt an outside director. The very idea of a "standard explanation form" is inconsistent with the purpose of the "comply or explain" approach. The approach presupposes that the optimal board structure is unique to each firm, and therefore the law should not impose a single rule on all firms. Firms that choose not to comply are expected to explain their reasons for deviation. If all firms adopt the "standard explanation form," thus refusing meaningful explanation specific to a particular firm, the "comply or explain" approach would have no influence on firms' choices. Each firm can safely continue its current board structure free from the fear that investors or the market would not be satisfied with its explanation because almost all firms would have adopted the same explanation.

Although the "comply or explain" approach has advantages, further studies are needed to determine whether and how it works in the real world.

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9 Iain MacNeil and Xiao Li, Comply or Explain: Market Discipline and Non-Compliance with the Combined Code, Corporate Governance: An International Review, Vol. 14, Issue 5, 2006.

VI. Conclusion

In the recent corporate law reform, the Legislative Council of the Ministry of Justice adopted a "soft" approach to regulate board structure. While the revision is a result of political compromise, the solution has a theoretical background.

As is explained in Part III, recent empirical studies, unlike traditional ones, have shown that board structure could affect firm value. They also suggested that Japanese listed companies choose inefficient board structures. Arguably, these findings provide a basis for legal intervention.

At the same time, recent studies assume that an optimal board structure differs from firm to firm, and therefore it is not advisable to introduce a single standard that all firms should follow. This would justify the "comply or explain" approach to regulation adopted by Legislative Council.

However, it is an open question whether this approach works in realty. There have been both positive and negative views with respect to the experience in the United Kingdom, which adopted the approach two decades ago. How it will work in Japan after the new legislation remains to be seen.