CORPORATE GOVERNANCE AND EXECUTIVE COMPENSATION: EVIDENCE FROM JAPAN

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Lawmakers around the world are now urging corporations to adopt governance and executive pay standards drawn largely from the American corporate law context. Yet little is known about how corporate governance actually influences executive compensation decisions outside of the United States—and whether adoption of these standards is likely to be desirable for investors abroad.

In this Article, we take advantage of a recent change in Japanese law to provide the first direct empirical evidence on executive pay in Japan. The evidence provides striking detail on the amount and structure of Japanese executive compensation. The data point to a previously unappreciated link between corporate governance and executive pay in Japan and indicate that several trends familiar to the U.S. compensation landscape have begun to take hold in Japanese firms. Our findings suggest that lawmakers and firms should take careful account of the relationship between

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governance and pay before importing governance standards from abroad.

I. INTRODUCTION

In the aftermath of the recent financial crisis, the finance ministers of all G-20 nations called on the Financial Stability Board to propose global standards on compensation structures that would govern the pay of bank executives around the world.[1] Although the standards are limited by their terms to banker pay, practitioners have made clear that the G-20's call for convergence on compensation practices has already had significant influence for firms across the global economy.[2] The standards draw heavily on the U.S. experience with executive compensation, favoring arrangements designed to address the agency problems that, some have argued, influence pay at large American public companies. Yet the standards, like most of the theoretical literature developed by academics, do not take account of the profound differences in corporate governance around the world—and the potential influence of those differences on executive pay.

In this Article, we contribute to the literature on the relationship between governance and executive pay by providing the first empirical evidence on the magnitude and structure of the compensation packages of Japan's most highly paid executives. Taking advantage of a recent change in Japanese law that requires, for the first time, extensive disclosure on the compensation of individual executives at Japanese public firms, we develop a proprietary, hand-drawn

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1 *See* FINANCIAL STABILITY FORUM, FSF PRINCIPLES FOR SOUND COMPENSATION PRACTICES 1 (2009).

2 CALVIN JOHNSON & KATY BENNETT, WATSON WYATT WORLDWIDE, EXECUTIVE PAY PRACTICES AROUND THE WORLD 3 (2009) (describing a "thrust in recent years toward convergence [in] . . . executive pay practices.").

database including detail on the amounts and elements of executive pay for Japan's highest-paid managers. The evidence provides striking new detail on executive pay in Japan—and new insights on the relationship between corporate governance and top managers' compensation.

First, we find, consistent with previous work, that Japanese managers generally receive considerably less total pay than U.S. executives. Second, we find, also consistent with previous work, that the structure of executive pay in Japan relies far more heavily on payments unrelated to performance, such as salary, than do pay structures in the United States. But the closer look permitted by our data suggests an important divergence in pay practices among Japanese firms—depending on whether the firm features the traditional Japanese corporate governance approach or a committee-based structure more familiar to American corporate law.

For example, we find that executives at firms governed in the U.S. style receive far more pay in the form of performance-based elements such as bonuses and stock options than their counterparts at traditional firms. We also find that the relationship between firm size and executive pay—a relationship familiar to the U.S literature on executive pay—is far less strong at traditionally governed Japanese firms than it is at firms governed by committees. Moreover, we find that at firms with traditional board structures, the gap between the compensation of top executives and the average member of the board of directors is relatively small, and shrinks as the firm grows in size. By contrast, at companies with committees, the gap between top executives and the average director grows considerably along with firm size.

Similarly, the influence of global markets in executive services is a critical determinant of executive pay inside Japan. On average, non-Japanese executives, whose pay is determined by international trends in executive pay, earn about forty percent more than Japanese executives, even controlling for differences in firm size and performance. And the structure of compensation is also profoundly influenced by global pay practices. Non-Japanese executives receive fifty percent more of their compensation in the form of stock options in comparison to their Japanese counterparts.

On balance, our findings suggest a considerably more nuanced pattern of Japanese pay practices than previous analysis has exposed. Most intriguingly, we find preliminary evidence that Japanese firms that have adopted U.S. board structures have also adopted U.S. pay practices, if on a more modest scale. We consider whether this trend may result from simple endogeneity, signaling, familiarity with a standard set of off-the-rack governance practices, or a causal relationship between governance structures and executive compensation.

Finally, our data provide new insights on the continuing debates over the effects of rapid recent adoption of corporate governance reforms in Japan. We conclude that the data are inconsistent with the view that these reforms have had no effect on the actual governance of Japanese public companies. We also note, however, that the evidence provides little support for the view that Japanese managers have adopted with unambiguous zeal all of the features of the shareholder-centric corporate governance model of the United States.

The Article proceeds as follows. Part II describes the relationship between corporate governance and executive pay in the United States and Japan. Part III describes the first direct evidence on top executives' pay in Japan. In Part IV, we consider the implications of our findings for corporate governance and executive compensation standards around the world. Part IV concludes.

II. CORPORATE GOVERNANCE AND EXECUTIVE PAY

The bulk of the extensive literature on executive compensation has focused on the pay bargains struck between boards of directors and top executives at U.S. public