CORPORATE GOVERNANCE CHANGES IN THE TWO LARGEST ECONOMIES: WHAT'S HAPPENING IN THE U.S. AND JAPAN?

Makoto Toda* and William McCarty**

INTRODUCTION

Lawmakers in the world’s two largest economies, the United States and Japan, have enacted legislation to require firms to at least consider altering their governance structure. In the United States, the 2002 Sarbanes-Oxley Act (SOX) and Securities and Exchange Commission (SEC) rules have led to revised governance structures at the 30 Dow Jones (DJ) companies. The governance changes affect the composition, size and functions of the board of directors and its relations with the chief executive officer (CEO). Research findings reveal some distinct governance elements that other firms may want to consider using. A 2003 change in the Japanese Commercial Code provided firms with three governance options, including a “Company with Committees” system similar to that found in U.S. firms. To date, only a small percentage of Japanese firms are selecting that system. While the hesitancy to change is grounded in cultural components of the existing corporate governance structure, there is clear evidence that the strength of those factors is diminishing.

In the DJ 30 firms, the size of boards has decreased and independence of board members appears to be increasing. We note, however, that having a majority of directors who are from outside the firm, as is true of all firms surveyed, does not always result in an independent board. Outside directors may lack independence, and it is independence among directors that is vital to effective corporate governance. Usually the CEO is the only insider on the board and the CEO is usually, but not always, the chairman of the board. The relationships between boards and external auditors vary little due to the SOX requirements.

* Makoto Toda is President of Nissay Credit Guarantee Company, a subsidiary of Nippon Life Insurance Company and a former senior managing director of Nippon Life. He is a Visiting Professor at Aoyama Gakuin University.

** William McCarty is Professor of Law and International Business at Western Michigan University and a fall 2004 Fulbright scholar and Visiting Professor at Aoyama Gakuin University.
In Japan, there has been a reduction in the size of boards and a small increase in the number of outside board members. As in the United States, the CEO is often dominant in selecting board members. Japanese firms now have three governance options available and each, particularly the new “Company with Committees” system, is examined here along with the reasons why firms either change or decide not to do so. We endorse allowing firms to adopt different governance systems to accommodate special needs as well as country, corporate and cultural concerns. Each country’s system has improved the outlook for more effective corporate governance. The U.S. legal changes are already quite extensive, but specific additions to the Japanese Code are needed to obtain clearer oversight by corporate boards. Greater use of independent directors and the separation of the CEO and Chairman roles by firms in both countries would enhance corporate governance.

A. Impetus for Governance Reform in the U.S. and Japan

In the United States, corporate governance reform emerged after widespread financial scandals came to light. According to reports compiled by Bloomberg.com and yahoofinance.com, as of August 2002 the scandals at Enron, Global Crossing, Adelphia, Tyco, Xerox, WorldCom, Arthur Andersen, ImClone and a few other firms led to billions of dollars in lost stock value and at least one hundred thousand lost jobs. More than a dozen corporate financial reports were found to contain misstatements and omissions that likely were deliberate attempts to provide misleading or false information. A few corporate executives engaged in criminal behavior; additionally, the CEO and the board of directors at most of those firms generally claimed to be unaware of what was happening under their supervision. The lack of supervision by the board also emerged as an issue when examining CEO compensation. Were the directors who established the CEO’s salary, bonuses, stock options and executive perks too easily influenced by the CEO? Shareholders, particularly the large institutions, were angry at corporate boards and officers. In the U.S., pension fund managers and other institutional investors, not silent individual investors, now control more than 50% of U.S. corporate equity. Although criminal and civil cases

1. See ‘Perp Walks’ and Watchdogs Can Thwart Corporate Crime, USA TODAY, July 9, 2004, at 10A. This editorial notes that indictments and criminal charges have been brought against executives at Enron, WorldCom, Adelphia, Tyco and Health South. Since January 2002, the federal Enron Task Force has charged 29 former Enron executives and outside advisers with crimes associated with Enron’s accounting fraud. Id.

are still pending against many executives involved in the scandals, the U.S. Congress quickly reacted to the outrage by passing the most significant corporate accountability change in several decades—the Sarbanes-Oxley Act.3

In Japan, the primary reason for governance reform was the realization that Japanese corporations must reform business operations and organizational structures to remain competitive with U.S., European and Chinese firms. A second agent for reform was the dramatic change in the composition of shareholders. Banks and other stable customer or supplier firms that owned and were owned by keiretsu partner firms once were dominant shareholders; however, in recent years institutional funds and individual investors have grown in influence.4 With cross-shareholding clearly diminishing, many Japanese firms no longer could count on shareholders whose concerns were focused more on long-term business relationships than on the return on their investments.5 Instead, they now must react to concerns about corporate profitability and a firm’s return on investment from institutional investors in Japan and abroad. Finally, as in the United States, Japan has had a number of corporate scandals that have diminished investor trust in Japanese corporations. In Japan, when corporate scandals involve illegal or unethical behavior, usually some officers resign in disgrace, but little change in corporate accountability occurs. Scandals have affected such well-known enterprises as Yukijirushi Nippon Meat Packer and Tokyo Electric in the past few years.6 At Yukijirushi, because the management did not know how to react to a major food poisoning scandal, the firm

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3. See ‘Perp Walks’ and Watchdogs Can Thwart Corporate Crime, supra note 1. As of July 10, 2004 five Enron executives, including Chairman Kenneth Lay and CEO Jeff Skilling are currently awaiting trial. John Rigas, the former CEO of Adelphia has been convicted, but former CEOs Bernard Ebbers of World Com, Dennis Kozlowski of Tyco and Richard Scrushy of Health South each awaits trial on fraud-related charges. See id. A detailed report on who has been charged, who is being questioned and why is available from CBS Market Watch at http://cbs.marketwatch.com/news/features/scandal_sheet.asp (last visited Mar. 29, 2005); see generally 15 U.S.C. §§ 7201-7266 (2002).

4. See Hidetaka Kawakita, The Attitude of Investors Since 1990s, 32 NISSAY RES. INST. 47 (April 2004). The report notes that the Japanese capital market is now changing to the place where individual investors as well as institutional investors have grown in influence. Id.


went bankrupt. Executives were forced to resign due to the mislabeling of beef at Nippon Meat Packers and because false inspection data was used to conceal problems at nuclear power plants operated by Tokyo Electric. Even Mitsubishi Motors was caught in covering up decades of customer complaints about defective vehicles.

I. LEGAL REFORMS IN THE UNITED STATES

In the United States, after the eruption of numerous corporate scandals and an outcry to do something to ensure such scandals would not continue, Congress enacted the Sarbanes-Oxley Act on July 30, 2002 and created a new Public Company Accounting Oversight Board to oversee the audits of public companies. Some major provisions of the Act deal with whom in the firm is responsible for internal controls and financial reporting, the authority and expertise of the audit committee and the role of the audit committee vis-à-vis external auditors. Its provisions affect officers and directors of public companies and mandates changes in the relationship between the firms and their outside auditors. The Act affects U.S. public companies, foreign firms (including, of course, some Japanese firms) subject to the U.S. securities laws, public accounting firms and regulatory bodies like the New York Stock Exchange (NYSE) and NASDAQ. Since the Act’s passage, both the SEC and the major stock exchanges have imposed new requirements on public firms.

The SEC has adopted a dozen major rulemaking initiatives in response to the Act’s requirements. The rules deal with insider trading reports, the independence of outside auditors, the need for board approval of auditor services, new and accelerated disclosure requirements and reports on internal controls over financial reporting.
Both the NYSE and NASDAQ also address the independence of board members, as well as other issues noted infra. Taken together, the Sarbanes-Oxley Act, the SEC rules and the NYSE and NASDAQ rules address three main areas of corporate governance: corporate accountability and disclosure, the independence of the board of directors and the role of auditors.\(^\text{12}\) As the independence of the directors affects both the role and compensation for the CEO, the CEO’s role vis-à-vis the board also has become a governance concern.

**A. Corporate Accountability and Disclosure**

According to agency theory, the board of directors of a corporation is accountable to the shareholders who elect them and corporate officers are accountable to the board of directors who place them in charge of day-to-day operations. In the United States, the board’s primary role is seen as providing oversight or monitoring to ensure the actions of its managers are effective, legal and even ethical. Although board members are there to monitor the actions of the managers, some board members in firms involved in the financial scandals said they did not know about their firm’s significant financial activities. Enron’s Board was criticized for failing to ask pertinent questions or to seek explanations regarding the nature of the partnership transactions that moved debt off the firm’s balance sheet.\(^\text{13}\)

In addition to being accountable to their owners, modern stakeholder theory usually holds the corporation’s board of directors accountable to its stakeholders—employees, suppliers, customers and community officials.\(^\text{14}\) According to Professor Cindy Schipani of the University of Michigan Business School:

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the accountability of corporate boards in corporate governance has evolved over the years, and, courts and legislatures often are caught in balancing acts. Historically, the challenge was to strike a balance between holding directors accountable to shareholders and not overly constraining their ability to perform their job. But these are not the only balances that need to be considered. Most states permit that in making certain corporate decisions, officers and directors can consider the welfare of other corporate constituencies in addition to shareholders. Once the facts of the Enron and other situations fully come to light, questions will arise not only about accounting practices and regulations but also about the role of the board of directors and its oversight function. Only time will tell how these issues will be resolved, but it wouldn’t be surprising to find the courts and legislatures strengthening the board’s oversight function in an effort to promote more corporate accountability. 15

Corporate laws in the United States, which require directors to act in an informed manner, do give directors and officers the flexibility to balance shareholders’ interest against other stakeholders. 16

The corporate scandals also brought to the forefront another problem, ensuring the accuracy of information. Although it may seem reasonable to assume that the CEO is the one person who in the end is accountable for all corporate information, the legal responsibility for certain information needs to be clear. Former Enron CEO Jeffrey Skilling said he was unaware of the company’s questionable partnership practices that were used to conceal debt from Enron shareholders, “this was a very large corporation. It would be impossible to know everything going on.” 17

Because of such statements, the Sarbanes-Oxley Act requires both the CEO and the CFO to sign and file, with the company’s 10K and 10-Q forms, their certifications regarding the effectiveness of the

company’s internal controls over financial reporting as well as the adequacy and accuracy of disclosures contained in the reports. The Annual Report must contain an “internal control report,” which shall state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting. At the end of the issuer’s fiscal year, a report must assess the effectiveness of the internal control structure and procedures of the issuer for financial reporting.

B. Independence, Size and Knowledge of the Board of Directors

Boards of directors are crucial to a strong corporate structure. While managers are selected to operate the firm, the directors “are representatives of the shareholders, whose purpose under the law is to safeguard the assets of the corporation.” The distinction between the board as a monitor of managers and also as being responsible for the use of firm assets is not always clear, particularly where the board member is also an executive of the firm. The independence of board members is critical because the board occupies an important role: “it must balance two distinct powers—the power of those who own the corporation and the power of those who run it. A corporation depends on shareholders for capital, but reserves the day to day running of enterprise for management.”

Board members are supposed to exercise their independent judgment in making corporate decisions. However, while directors are elected by corporate shareholders, in practice their selection usually can be traced directly to the CEO. This may be particularly true because U.S. board members, who usually are all from outside the firm, may be unable to devote sufficient time or have the requisite knowledge of the firm’s problems. Consequently, they are unable or unwilling to impose restraint in setting either CEO or board members compensation and benefit packages or to challenge operational plans favored by the executives. In the United States, the push for greater outside representation on boards started in the 1970s because outside directors were thought to bring greater independence to their oversight role. However, Cynthia Glassman, a SEC Commissioner, noted in a recent

speech that "[a]s we examined various scandals that had occurred, director independence increasingly was seen as a missing element necessary to position the [b]oard to oversee management, foster integrity and prevent such misbehavior from occurring." Thus, while U.S. directors, unlike their Japanese counterparts, usually are from outside the corporation, their friendship with and dependence upon the CEO means they lack needed independence.

Although both the NYSE and NASDAQ now require a majority of a publicly traded corporation’s board to be independent, they differ slightly as to how to best determine such independence. The NYSE specifies that a director who has a “material relationship” with the listed company cannot be considered independent. The NASDAQ directive defines an “independent director” as one who is not an employee of the company and who does not have a relationship which, in the opinion of the company’s board, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director. Companies listed on the exchanges must, with some exceptions, have compensation and nominating committees composed solely of independent directors. The SEC rules support requiring the nominating committee members to be independent of management. Under the Sarbanes-Oxley Act, the NASDAQ and NYSE will be required to de-list companies that do not comply with the new rules on independence.

To be effective, boards must have some meetings at which only independent members are present. To help insure independence and lessen the possibility of conflicting interests affecting the judgment of board members, directors’ fees must be the sole compensation for independent directors, although these fees can vary due to different director responsibilities. The payments can be in cash, stock and/or


23. NASDAQ’s Rule 4200 (a)(14), (15) prohibits a former employee of a public company or any of its subsidiaries if employed during the preceding three years or whose relative accepted $60,000 or more during said period from the company to be considered independent. Id.

24. See SEC Notice 68 Fed. Reg. 64154 (Nov. 4, 2003) (noting NYSE and NASDAQ Rules that allow for a non-independent director to be a member of the nominating committee if the board, under exceptional and limited exceptions, determines that to be in the best interest of the company and its shareholders).

25. Id. The SEC statement reads “The Commission believes that directors that are independent of management are more likely to support the nomination of qualified independent directors and that a written document governing the nominating committee is beneficial.” Id.
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options. Public companies are prohibited from making, or arranging for, personal loans for any director or executive officer.\textsuperscript{26}

In addition to the selection process and independence of directors, the size of the board may have an influence on a board's effectiveness. A board that is too big may be unworkable.

In 1993, Rawleigh Warner, a director of American Express at the time, noted, "the size of a [b]oard does make a difference. The American Express Board had 19 members and four advisors to the Board. That large a board, I believe, makes for an unwieldy number and prevents an opportunity for each member to speak freely."\textsuperscript{27} Warner's comments seem to have been listened to. According to Spencer Stuart's survey of large U.S. companies, the average board size was 15 in 1988 and 12 in 1998. Our survey shows the average size of boards at the 30 DJ firms in 2004 was 12.5.\textsuperscript{28}

A final issue related to corporate directors concerns their knowledge, particularly of financial and accounting issues. Members of the Enron board of directors have been criticized for their lack of attention to the off-book financial entities with which Enron did business. Special requirements for the audit committee of the board are discussed below. Similarly, there is a need for the board of directors to make sure they have access to all needed information. The directors should have ultimate approval over information flow to the board, meeting agendas, and meeting schedules to ensure that they have sufficient time for discussion of all agenda items.\textsuperscript{29}

C. The Role of Auditors and the Audit Committee

The Enron scandal, which caused the downfall of Arthur Andersen, also raised questions about the duties and responsibilities of a firm's auditors. When lead partners and local offices derive significant parts of their income from a key client, objectivity may disappear. Auditors who have long-standing relations with their clients may lack the critical eye that is necessary to the performance of their tasks. As for internal auditors, they need to make sure that they, as well as the directors on the board's audit committees, have access to necessary information. Robert

\textsuperscript{27} MONKS AND MINNOW, supra note 21, at 166.  
\textsuperscript{28} See Table 1 infra at 208.  
Jaedicke, a former Stanford Business School Dean, stated to lawmakers that he and other members of Enron's audit committee were misled through years of inaccurate earning reports. He said:

The lifeblood of the work of any [a]udit [c]ommittee is the development and implementation of adequate controls, many of which cross check each other. And the oversight function of the [c]ommittee depends on the full and complete reporting of information to it. Without full and accurate information, an [a]udit [c]ommittee cannot be effective. 30

He blamed Enron's management and outside consultants for providing incorrect information.

Both Sarbanes-Oxley and the NYSE requirements include provisions to increase the authority and responsibilities of the board's audit committee and to ensure that it has the necessary independence and expertise. 31 The audit committee must have the sole authority to hire and fire a company's independent auditor and to pre-approve any significant non-audit relationship with the independent auditor. The audit committee also must have the ability to engage independent counsel and other expert advisors. 32 SOX requires that each member of a publicly traded board's audit committee must be "independent." Under this requirement, a director is not independent if the director has received any consulting or other fees outside his or her capacity as director or committee member, or if the director is affiliated with the company or its subsidiary. This standard excludes from audit committee membership representatives of large stockholders, and it is stricter than the NYSE and NASDAQ rules, which include some exceptions. 33

At least one director must qualify as a financial expert who, among other things, understands generally accepted accounting principles and has experience in preparing, auditing, analyzing or evaluating financial


33. See Gray, supra note 29.
statements that present a breadth and level of complexity of accounting issues reasonably expected to be raised.\textsuperscript{34} Professor Hideki Kanda of Tokyo University, suggests that both independence and "financial literacy" should be required for all members of a board's audit committee.\textsuperscript{35} New NYSE and NASDAQ requirements specify that all members of an audit committee must be financially literate, with at least one member having extensive accounting or financial management expertise.\textsuperscript{36} Additionally, SEC rules require firms to disclose whether they have an "audit committee financial expert" on the committee and if not, why not.

Since external auditors are hired to check on the corporation's financial records, it is unlikely that corporate executives who are responsible for maintaining those records will want aggressive independent auditors if the executives themselves have reason to believe the records can be questioned. Responsibility for hiring external auditors should rest with independent board members, not with corporate executives in charge of financial records. As auditor independence is a crucial issue for corporate governance, SOX imposes several requirements related to partner rotation, auditor's reporting, cooling off period, and prohibited activities. Auditors are also prohibited from providing other work such as appraisal or valuation services, actuarial services, investment banking services and legal services unrelated to the audit.\textsuperscript{37}

II. LEGAL REFORMS IN JAPAN

Japan's revised Commercial Code, effective April 1, 2003, sought "to create a corporate governance system so as to revitalize Japanese corporations and to establish a corporate decision-making system with greater agility and mobility."\textsuperscript{38} Some proponents of change wanted to require all major firms to adopt a new governance system, but when business opposition arose, the compromise of offering options,
including the option of not making any change, was adopted.\(^39\) "The option to use a ‘Company with Committees’ system was intended to make clear the distinction between the oversight and operational function in a corporation."\(^40\)

Several major cultural elements found in most Japanese firms stand out as affecting corporate governance. They include the development of harmony and the use of a different decision-making process among lifelong corporate employees; the central role of a main bank; and the cross-shareholding among keiretsu members. However, the new reality is that the influence of these factors has been significantly diminished. The decline in the use of each of these attributes of Japanese corporate culture has led firms to examine their corporate structures and to place greater emphasis on profitability and the return on investments.

**A. Cultural Elements Affecting Corporate Governance**

Decision-making processes in Japanese corporations differ from those in use in the U.S. For example, based on the Japanese philosophy of “ringiseido,” participative decision-making from various levels is considered to stimulate group harmony and to provide a feeling of participation.\(^41\) While it takes patience to work through the decision-making process, those who have participated through the “ringi” process see it as their responsibility to implement the decision. The strength of communication and mutual understanding among multiple levels of management played an important part in the development of the corporate culture while also providing trust and stability that allowed firms to reduce monitoring and reporting costs. However, as decisions are based on a consensus, where no one decision-maker can be identified, the process is very weak on accountability.

Another unique feature of the Japanese governance system has been that banks, which were key shareholders of many firms, frequently served as external monitors in charge of a corporation’s governance. A “main bank,” generally had a very special relationship with one or more companies and served multiple functions: providing loans, serving as a major shareholder and dispatching their own staff to serve as company

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These “main banks” were positioned at the very core of corporate governance. Ryuji Konishi, a former managing director of Long Term Credit Bank, speaking about the role of banks in corporate governance noted:

Banks centered on top of the government system. Banks intervened in a company’s management at the time of its financial distress. Banks reinforced mutual relationship among stakeholders through cross shareholdings. Banks thought it was them who maintained and drove the system. They thought they were the Governor of the system. All the stakeholders’ relationship and even the Market were often internalized by the banks and there had been lack of [sic] pure outsiders’ check system. It is quite an irony that they thought they were the master of the system and ordered others to do this and that for restructure, proved merely a puppet of MOF and awfully inept to tackle with their own restructuring.43

Also unique to Japan is the nature of “cross shareholding” among companies, particularly with banks. Initially, cross shareholding centered on the former zaibatsu groups for the purpose of preventing the hoarding of stock after the liberalization of securities in the 1950s.44 In the 1960s cross shareholding was used by companies with close business relationships, such as keiretsu or corporate groups, and to prevent stock acquisition by foreign companies. In the 1980s cross shareholding aggressively promoted large volume equity financing during the “bubble” economy period. Benefits of cross-shareholding include stable management as the shareholders back the managers and reinforcement of existing business relations especially if the returns from the stock investments in partner firms increase in value.

Each of these components of Japanese corporate culture has changed, some of them quite dramatically, in the last two decades. Globalization has forced many firms to move operations into China and elsewhere so the process of continually hiring new university graduates
and impliedly guaranteeing them life-long employment has had to be discarded at many firms. Thus, the close relationships among workers and their managers, most of whom were lifetime employees, are changing. The main bank’s role has likewise declined. Due to the deterioration of the banks due to bad loan problems, bank financing has been gradually replaced by fund procurement in capital markets. As a result, the main bank’s influence on corporate governance has diminished. Similarly, although cross-shareholding brought benefits when stock prices rose, as prices continued to drop, firms began to sell cross-shareholdings. In the last decade both stable long-term shareholding and cross shareholdings have decreased significantly, with cross-shareholding falling to 7.2% in 2002, only half the level that existed a decade earlier.\(^{45}\)

As a result of the changes, more firms are now without strong bank financiers and keiretsu allies, who can be counted on to help look after their common interests. To be competitive in the global marketplace both the sourcing and methods of operations and the attraction of needed capital have to be more in line with global standards. Firms looking for global recognition, markets and capital were expected to eliminate corporate scandals and “to attain better performance through an enhanced corporate governance structure.” \(^{46}\) In matters specifically related to corporate governance, the firms found that the U.S. system operated as a \textit{de facto} global standard. \(^{47}\)

\textbf{B. Recognition of the need for Corporate Governance Reform}

In addition to experiencing the changes occurring in Japanese corporate culture, the occurrence of several scandals in the late nineteen nineties and the early years of the new millennium convinced many executives and their advisors that compliance with legal and social standards, along with meeting higher investment performance expectations, are keys to corporate governance. Attorney Hideaki Kubori notes,

\begin{quote}
Nowadays, just one inappropriate act by an on-site employee can destroy a brand name and ruin a company. The
\end{quote}

\(^{45}\) See Kuroki, \textit{supra} note 5, at 1.


\(^{47}\) Etsuko Katsu, \textit{GLOBAL CAPITAL REVOLUTION} 14, 21, 25 (TOYO KEIZAI SHINPOSHA 1998).
time is now for top management to urgently build a system in which compliance takes root, through methods most suited to the company. If compliance is deficient, the all-important brand image will be seriously tainted. And damage to brand leads directly to the collapse of company organization. A definitive example is the food poisoning incident at Yukijirushi that began on June 27, 2000, the day before the shareholders meeting. 48

Another important aspect of corporate governance is to attain better performance. If companies do not take reasonable risks, better performance (return) cannot be created. Professor Takeaki Kariya of Meiji University concludes, "No uncertainty, no need for management." 49

As board members were almost always also corporate managers, the composition of the boards made it unlikely that the board would monitor managers. Instead, statutory auditors functioned to monitor both the execution of actions taken by the board and the internal control and conduct of the company. 50 Although statutory auditors are used in several countries, their role is not well understood. The statutory auditor generally exists as a means of "monitoring the legal conformity of business conducted by directors." 51 Generally, statutory auditors in Japan have been executives of other companies, people from a firm's main bank, its lawyers, or people with which the firm has continuing business relationships.

In 2001, the Commercial Code was revised to strengthen the auditing system in several respects. Nobuo Nakamura, Professor of Law at Waseda University explains several of the changes. First, the revision requires that a resigning auditor be granted the right to state his or her opinions at the shareholders meeting. 52 Second, the length of term served by a statutory auditor was extended from three to four years as of

48. See Kubori, supra note 6, at 1.
49. See Takeaki Kariya, Fudosan Kinyukogaku towa nanika [What is the financial engineering about real estate?], TOYO KEIZAI SHIMPOSHA, at 17 (2003).
December 2001.\textsuperscript{53} It also increased the number of statutory outside auditors to three or more and requires that the majority of auditors be from outside the firm.\textsuperscript{54} Under the new definition outside statutory auditors must not presently be, nor have been a director, a general manager, or an employee in some other capacity of the company or its subsidiaries.\textsuperscript{55} Finally, the 2001 revisions require “the board of directors of large corporations to secure approval from the board of statutory auditors before submitting a slate of statutory auditors for approval at a shareholders meeting.”\textsuperscript{56} As of the first shareholders’ meeting occurring after May 1, 2005, the 2001 Code revisions impose the changes on the statutory auditors of all firms not opting for the new “Company with Committees” governance system.

\textbf{C. The 2003 Revisions in the Japanese Commercial Code}

Prior to the April 1, 2003 changes to the Commercial Code, aside from the role of the statutory auditors, boards in Japanese firms appeared to serve the same function as their U.S. counterparts.\textsuperscript{57} The board of directors elected by shareholders (and thus responsible to them) sets overall corporate policies and direction and appoints and monitors the company executives who implement these policies. The reality, however, was that as the members of the board were all from inside the firm, the interests of the employees, as distinct from the interests of individual managers and employees, was paramount in the board’s decision-making.

The distinction between oversight and operational functions has not been clear because the members of the board of directors were also executives in charge of company operations. The Code acknowledges the dual role of board members. According to Commercial Code § 260 (1), “The board of directors decides the operation of a company and monitors the execution of directors.”\textsuperscript{58} The reality of the governance structure of Japanese companies has been as follows:

\begin{itemize}
  \item 53. Commercial Code § 273 (1).
  \item 54. The Japanese Law for Special Exceptions to the Commercial Code Concerning Audits, etc. of Corporations § 18 (1).
  \item 55. See id.
  \item 56. Nakamura, supra note 52, at 7.
  \item 57. See Stephen Prowse, Corporate Governance in International Perspective: A Survey of Corporate Control Mechanisms Among Large Firms in the United States, the United Kingdom, Japan and Germany, Bank for Int’l Settlements Econ. Papers No. 41, 43 (July 1994).
  \item 58. Commercial Code § 274 (1).
\end{itemize}
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1. Almost all directors are appointed or, to be more exact, promoted internally.

2. Almost all directors are also executives or managers who therefore face conflicts on many matters. There is no clear distinction between monitoring and operating.

3. The outgoing CEO usually appoints a new CEO.

4. The power and authority of CEOs is often not questioned.

The 2003 revised Commercial Code gives companies three options for their governance system: (1) keep their conventional governance system; (2) establish a decision-making committee regarding major assets in addition to a corporate auditor system; or (3) establish a new corporate governance structure known as the "Company with Committees" system. For companies electing the first choice, the only change in the decision-making of the board is the change required for the statutory auditor. As for the second choice, the purpose of setting up a major asset committee is for it to make decisions relative to the disposal of important assets of a company. Traditionally, only the board of directors could make such decisions. The determination by a firm to have a major asset committee can be decided by a board of at least 10 members and one outside director. The major asset committee must be composed of at least three board members. Although to date only Honda has adopted this system, it is anticipated more companies will do so. Honda explained its adoption of this system in its recent financial report: "In order to ensure proactive decision-making, the Board of Directors set up an Assets and Loan Management Committee, which is responsible for making decisions related to the disposal of the Company's important assets." If the third choice is elected, three committees and the representative corporate officer system replace the conventional corporate auditor system. Toshiba Corporation captures the possible benefits of the new governance system:

[U]nder the previous Commercial Code, the board of

59. The Japanese Law for Special Exceptions to the Commercial Code Concerning Audits, etc. of Corporations at § 1-2 (3).
60. See id. § 1-3 (1).
61. See id. § 1-3 (3).
directors was legally responsible for both execution and supervision. Under Japan’s revised Commercial Code, the Company with Committees system articulates a division of legal responsibility between the executive officers and the board: It provides for executive officers to execute business, while the board concentrates on supervision of management. Executive officers will be able to act with greater agility and mobility to meet the challenges of the business environment.63

The committees required include an audit committee, nominating committee and compensation committee. As the Toshiba note suggests, the major change with this system is that firms must transfer to executives who are not members of the board the responsibility for running the business.64

D. Governance Under the “Company with Committees” System

Toshiba explained the purpose for its adoption of the new governance system “as a means to further enhance corporate governance by reinforcing supervisory functions and management transparency and to improve operating agility and flexibility.”65 Other companies that select this option likely anticipate that as they become more accountable, they will also be more competitive by increasing their corporate value and eliminating corporate corruption through the enhanced corporate governance system.

The audit committee monitors both the appropriateness and the legal conformity of business carried out by both directors and executive officers.66 The selection of external auditors must be approved by shareholders and the audit committee is empowered to submit to shareholders a proposal to elect and remove external auditors.67 All members of the audit committee are prohibited from serving as executive officers or employees of the company or any subsidiary, and


64. The Japanese Law for Special Exceptions to the Commercial Code concerning Audits, etc. of Corporations § 21-5 (1).

65. See TOSHIBA, supra note 63.


67. See id. at 237.
from holding management position in any subsidiary. There is, however, no provision that would bar keiretsu member representatives or others who have a material relationship with a firm from being on the audit committee. The nominating committee determines the content of proposals pertaining to the election and removal of directors at shareholders meeting. The board of directors retains the right to elect and remove members of the committees; the nominating committee is not involved in that function. The compensation committee determines the compensation for each director and executive officer. At least three board members are to be on each committee with the majority of committee members being outside directors.

As far as the independence of board members, company executives may serve as members of the nominating or compensation committee, but not of the auditing committee. Committee members cannot be regarded as outside directors if: (1) they are current or former employees, or (2) they are current or former directors working at the same time as executive officers of the company. Despite the changes, the newly revised Code in Japan does not ensure a board in this new system will be composed mostly of independent members who can perform the monitoring function without a conflict. This is because the Code does not require that corporations adopting the new system have a majority of outside directors on the board. Indeed, it permits directors concurrently serving as executive officers to constitute a majority. Moreover, the definition of “an outside director” does not require independence. Therefore, directors from a parent company, from a main bank or from companies with material relationships can be considered as outside directors. Thus, the definition of what makes a director independent is less restricted in Japan than in the U.S.

III. CORPORATE GOVERNANCE IN U.S. CORPORATIONS

The reforms imposed by the Sarbanes-Oxley legislation and the NYSE and NASDAQ rules require U.S. corporations to address a number of governance issues related to the size and composition of boards, the independence of board members, the separation of the CEO and chairman positions and several other related concerns. An examination of what is happening with these concerns in the 30 DJ

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68. The Japanese Law for Special Exceptions to the Commercial Code Concerning Audits, etc. of Corporations § 21-8 (7).
69. Id. at § 21-8 (4).
70. COMMERCIAL CODE § 188 (2), 7.2.
71. See MAEDA ET. AL., supra note 66, at 55.
Industrial firms is provided below. The role of the firm auditors and the expressed importance of non-shareholder stakeholders also are reviewed.

The governance changes occurring at these firms have been quite extensive. For example, General Motors developed guidelines in thirty-five areas ranging from the selection of new board members to the size of the board and the board’s relationship with senior management.\(^{72}\) GM’s guidelines included those involving the selection and composition of the board, board leadership, the board’s composition and performance, the board’s relationship to senior management, meeting procedures, committee matters and leadership development.\(^{73}\) General Electric’s Governance Principles include both the independence of directors and the independence of committee members. Meetings of non-employee directors, reporting concerns to non-employee directors and succession planning are also topics noted in the GE policies.\(^{74}\)

**A. Summary of Governance Structures at the 30 Dow Jones firms**

**TABLE 1: Composite View of DJ 30 Boards and CEO Governance**

<table>
<thead>
<tr>
<th>Board Size</th>
<th>The average board has 12.5 members.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of Inside Directors</td>
<td>The average number of inside directors is 1.8. Only 6 firms have more than 2 inside directors.</td>
</tr>
<tr>
<td>Who are the Inside Directors?</td>
<td>The CEO and Chairman are the only inside directors at 16 firms.</td>
</tr>
<tr>
<td>CEO &amp; Chairman</td>
<td>The CEO and Chairman are separated at 7 firms. The former Chair or President sits on 2 Boards.</td>
</tr>
</tbody>
</table>

* Data is based on home pages as of July 1, 2004.

Table 1 depicts a composite of the governance structure in the

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\(^{73}\) Id.

Dow Jones 30 as of July 1, 2004, and by extension in corporate America. The data shows the size of the board averages just over 12 members, with only one or two inside directors and with a firm’s CEO also being the chairman of the board.

Table 2, which depicts the size and number of inside members of the boards at each of the 30 Dow Jones’ firms, shows board size varies from as few as 9 members at Hewlett-Packard to as many as 17 at SBC. The average number of members is 12.5, with eight firms having 11 members and six having 12. Although one might expect most boards to have an odd number of members, in fact 60% of the thirty firms have an even number of members.

### TABLE 2: Board Size and Number of Inside Directors at DJ 30 Firms

<table>
<thead>
<tr>
<th>Firms</th>
<th>Board size</th>
<th>Number of inside directors</th>
<th>Position of Insiders</th>
</tr>
</thead>
<tbody>
<tr>
<td>3M Company</td>
<td>11</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Alcoa Inc.</td>
<td>11</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Altria Group</td>
<td>10</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>American Express</td>
<td>13</td>
<td>3</td>
<td>Chairman &amp; CEO</td>
</tr>
<tr>
<td>AT&amp;T Corp.</td>
<td>10</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Boeing Co.</td>
<td>10</td>
<td>2</td>
<td>President &amp; CEO, Non-executive Chairman</td>
</tr>
<tr>
<td>Caterpillar Inc.</td>
<td>14</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Citigroup</td>
<td>16</td>
<td>3</td>
<td>Chairman, CEO, President &amp; COO</td>
</tr>
<tr>
<td>Coca-Cola Co</td>
<td>16</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>DuPont</td>
<td>12</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Eastman Kodak</td>
<td>11</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Exxon Mobil</td>
<td>11</td>
<td>3</td>
<td>Chairman &amp; CEO, President, Executive Vice President</td>
</tr>
<tr>
<td>General Electric Co.</td>
<td>16</td>
<td>5</td>
<td>Chairman &amp; CEO, Vice Chairman (3)</td>
</tr>
<tr>
<td>General Motors</td>
<td>11</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Home Depot Inc</td>
<td>12</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Hewlett-Packard</td>
<td>9</td>
<td>2</td>
<td>Chairman &amp; CEO, Former Chairman</td>
</tr>
<tr>
<td>Honeywell Intl Inc.</td>
<td>14</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Company</td>
<td>Inside Directors</td>
<td>Total Directors</td>
<td>Position Description</td>
</tr>
<tr>
<td>----------------------------</td>
<td>------------------</td>
<td>-----------------</td>
<td>------------------------------------------</td>
</tr>
<tr>
<td>Intel Corp.</td>
<td>11</td>
<td>3</td>
<td>Chairman, CEO, President &amp; COO</td>
</tr>
<tr>
<td>IBM</td>
<td>12</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Intl Paper Co.</td>
<td>11</td>
<td>2</td>
<td>Chairman &amp; CEO, President</td>
</tr>
<tr>
<td>JP Morgan Chase</td>
<td>16</td>
<td>2</td>
<td>Chairman &amp; CEO, President</td>
</tr>
<tr>
<td>Johnson &amp; Johnson</td>
<td>13</td>
<td>2</td>
<td>Chairman &amp; CEO, Executive Vice President &amp; CFO</td>
</tr>
<tr>
<td>McDonald</td>
<td>12</td>
<td>2</td>
<td>Non-Executive Chairman, President &amp; CEO</td>
</tr>
<tr>
<td>Merck &amp; Co</td>
<td>12</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Microsoft Corp.</td>
<td>10</td>
<td>3</td>
<td>Chairman, CEO, Former President &amp; COO</td>
</tr>
<tr>
<td>Procter &amp; Gamble</td>
<td>16</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>SBC</td>
<td>17</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>United Technologies</td>
<td>12</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Wal-Mart Stores</td>
<td>14</td>
<td>4</td>
<td>Chairman, Vice Chairman, CEO, Chairman of the Executive Committee</td>
</tr>
<tr>
<td>Walt-Disney Co.</td>
<td>11</td>
<td>3</td>
<td>Chairman, CEO, President &amp; COO</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>374</strong></td>
<td><strong>55</strong></td>
<td></td>
</tr>
</tbody>
</table>

* When the column is blank, the only insider is the CEO.

** Data based on the firms’ home pages as of July 1, 2004.

As noted in Table 2, at the DJ 30 firms, each board of directors is composed of at least nine members, with an average of 12.5, and usually only one or two are inside directors. At 16 of the DJ 30 firms, the CEO, who is on all of the boards (or CEO who is also the chair) is the only insider. At two firms, Microsoft and HP, a former chairman or president is also on the board. Where two insiders are on the board, they are most commonly the CEO and a separate chairman. Only two boards, General Electric and Wal-Mart, have more than three insiders.

It is in this area that the greatest contrast between U.S. and Japanese boards exists. While almost all U.S. firms’ directors are outsiders, in Japan almost all board members are insiders. Japanese boards are less worried about monitoring the insiders than ensuring that the board members have the knowledge to make strategic decisions for the firm. Most officers in Japanese companies believe outsiders are less effective because they have less knowledge about the operations and
issues facing the company. Board members who are primarily outsiders will need to rely too much on the views and desires of those insiders.

A. Independence of Board Members

Having independent board members can be critical as American Express’s experience exemplifies. In 1992, the board, at the behest of several independent members, forced Board Chairman James Robinson to resign. Today, the governance policies at American Express define an independent director as follows:

“A director is independent if he or she does not have a material relationship with the Company.” Several specific situations include having an immediate family member who was employed as an officer of a subsidiary or being an executive of a company that does business with the firm and whose annual revenues from that business exceeds 1% of either company’s business. As of January 24, 2004, the board determined that “nine of the Company’s 12 incumbent directors were independent under these guidelines.”

Citigroup has a long-standing commitment to an independent board and stock ownership as the two most important components of its corporate governance policies. Furthermore, Citigroup has adopted a new policy that seeks to eliminate interlocking directorships. Citigroup’s governance policies include the following statements:

Director Independence: We have adopted corporate governance guidelines requiring that at least two thirds of our board should be independent.

Stock ownership commitment: Directors and members of Citigroup agree that as directors they will continue to hold at least 75% of the Citigroup stock that they own for at least a minimum specified period...

75. See MONKS & MINNOW, supra note 21, at 347.
77. Id.
78. Id.
80. Id.
Interlocking Directors: No inside director or executive officer of Citigroup shall serve as a director of a company where a Citigroup outside Director is an executive officer. 81

Finally, "Boeing’s existing governance principles call for a ‘substantial majority of independent, non-management directors.’ Indeed, nine of the eleven members of Boeing’s board of directors are considered ‘independent’ under the NYSE’s proposed tighter definition. Boeing’s board of directors also has regular executive meetings without management present, another NYSE recommendation." 82

B. Separation of CEO and Chairman Positions

If the chairman of the board of directors is also the CEO of the company, how can the board, under the leadership of its chairman, monitor the CEO and other executive managers of the company? If governance at a corporation is to include monitoring of executives by the board, the need to separate the positions of chairman of the board and CEO of the company seems obvious. In early 2003, the conference board recommended that the CEO and chairman positions be split with the chairman position filled by an independent director. 83

Among the Dow Jones 30 firms, only seven separate the position of CEO and chairman of the board: Boeing, Microsoft, McDonald, Intel, Wal-Mart, Walt Disney and Citigroup. In the remaining 76.6% of the 30 companies, the chairman of the board was also the CEO of the company. Several firms expressed strong reasons for their decision to separate the two positions. The Guidelines for Intel Corporation’s Board of Directors specifically require the separation of the position of Chairman and CEO as an aid in the board’s oversight of management. “The Board’s general policy, based on experience, is that the positions of Chairman of the Board and Chief Executive Officer should be held by separate persons as an aid in the Board’s oversight of Management.” 84 At Boeing, the company separated the position of CEO

81. Id.


84. Intel Corporation, Corporate Governance Guidelines—Intel Corporation Board of Directors Guidelines on Significant Corporate Governance Issues, available at
Corporate Governance in the U.S. and Japan

and non-executive chairman on December 1, 2003. Lew Platt, non-executive chairman, explained his new position by saying that: “I can take that load away from [Boeing President and CEO] Harry Stonecipher and focus on all the issues of running the Board, chairing the Board meetings, setting up the agenda for the meetings and handling all the governance issues.” While such a split is not the norm in either the United States or Japan, in the United Kingdom 95% of the 350 largest companies listed on the London Stock Exchange do split those positions.

In the U.S., the desirability of separating the two positions is subject to debate. The rationale for keeping one person in the two positions is not based on the board exercising its monitoring function, but on ensuring that only one person is in charge of the firm. A respondent to the 1992 Korn/Ferry survey concluded, “They should be the same person. If they are not, the Chairman would be a figure-head or would usurp the role of the CEO.” This view appears to be the dominant one in most of the top U.S. corporations. In 1998, CEOs were also the Chairmen of 93% of the largest companies. Our survey shows that in 2004, CEOs were Chairmen in 23 (77%) of DJ 30 firms.

The corporate governance guidelines of AT&T state: “the Company’s by-laws provide that the Company’s Chief Executive Officer shall also serve as the Company’s Chairman of the Board. The Board believes this policy has served it well in the past and continues to serve it well at present.” Until recently, Michael Eisner held both positions at Disney. However, the 2004 shareholders’ meeting at Walt Disney World was one of the most divisive in history for the firm as compared to meetings of other firms facing critical problems. Most of the issues centered on then CEO and Chairman Michael Eisner, who retained the position of CEO, but not the Chairman’s role. Former

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88. Korn/Ferry International, Board of Directors, Twentieth Annual Study (1998); see Table 1 for 2004 data at DJ 30 firms.

Senator George Mitchell, an Eisner supporter, later was made Chairman.

Shareholder representatives, who view the board as representing their interests, are increasingly calling for a separation of the position of chairman and CEO.\(^{90}\) Harold Green, former CEO and chairman of ITT Corp., poses the problem encountered when the CEO is on the board, whether as Chairman or as an inside member. "If the board of directors is really there to represent the interest of the stockholders, why is the chief executive on the board? Doesn’t he have a conflict of interest? He’s the professional manager. He cannot represent the shareholders and impartially sit in judgment of himself."\(^{91}\) The shareholders appear to be right in seeking to change the status quo. In terms of corporate performance two studies found that "companies with separate CEOs and chairmen consistently outperform those companies that combine the roles."\(^{92}\)

The 2004 study by Merrill Lynch’s chief U.S. market strategist, Richard Bernstein, showed a 22% return for firms where the roles were split versus 18% where they were combined.\(^{93}\)

\section*{C. Other Governance Characteristics in 30 DJ Companies}

Although most companies have adopted similar governance principles, a few have added details in critical areas while others have included principles not found in most other firms. We examined the role of the board’s audit committee and the expressed importance of non-shareholder stakeholders. As the authority of a firm’s audit committee has increased due to the provisions of the Sarbanes-Oxley Act, we looked to see if corporate governance principles reflect the heightened role for this committee? Similarly, we looked at whether firms make any express commitments to stakeholders other than shareholders and if so, which interests are of greater importance?

Both SOX and the NYSE requirements give the audit committee the sole authority to hire and fire a company’s independent auditor and

\(^{90}\) See Edward Iwata, To split, or not to split? USA TODAY, Mar. 17, 2004, at 48 (referring to the California Public Employees' Retirement System (Calpers) and labor unions as supporting a split); see also TIAA-CREF defends investor interests with updated statement on corporate governance, TIAA-CREF BALANCE, Spring 2004, at 5 (explaining that the Policy Statement on Corporate Governance states, “If a board doesn’t separate the positions of chairman and CEO, it should designate an individual who presides over executive sessions of independent directors.”).


\(^{92}\) Beck, supra note 86; MONKS & MINNOW, supra note 21, at 179-80.

\(^{93}\) Beck, supra note 86.
to approve any significant non-audit relationship with the independent auditor.\textsuperscript{94} The committee also must have the ability to engage independent counsel and other expert advisors. Additionally, SOX requires the SEC to propose rules for certifying that one member of the audit committee is a “financial expert.” The NYSE requires company boards to include nominating, compensation and audit committees, the same committees required under the revised Japanese Code’s Committee system of governance. A major difference, however, is that unlike the Japanese law, the NYSE rules require these committees to be composed solely of independent directors.\textsuperscript{95} As the law imposes rather specific requirements related to the audit committee’s role, we found the governance provisions for this committee to be similar at most firms.\textsuperscript{96}

The governance principles at Boeing exemplify such provisions. At Boeing:

Boeing’s board of directors already has Audit, Compensation, Finance, and Governance and Nominating committees. Only non-employee directors may serve on these committees. Audit committee members must be ‘independent,’ pursuant to NYSE rules. All key committees have written charters that address their purpose, goals and responsibilities . . . . The audit committee is responsible for evaluating and selecting outside auditors, subject to ratification by the full board. [It] also reviews the external auditor’s annual audit plan and report. The board of directors, or any of its committees, may seek legal or other expert advice from an independent source outside of the company.\textsuperscript{97}

As for stakeholders, several DJ 30 firms have express governance statements relating to stakeholders. Walt Disney states that it has a responsibility to the communities where it operates as well as to its shareholders. It requires management to report on its responsibilities to the board and notes that the board shall reflect the diversity of the

\begin{footnotes}
\item[95.] SEC Release No. 34-48745, supra note 94 (approving requirements stated in the NYSE Listed Company Manual § 303A).
\item[96.] SOX, Pub. L. No. 107-204, Title IV, § 301, 116 Stat. 789.
\item[97.] Boeing Company, supra note 82.
\end{footnotes}
Corporation's shareholders, employees, customers, guests and communities:

The Corporation has a responsibility to the communities in which it operates, as well as to its shareholders. To allow appropriate Board review and input, management shall prepare and present to the Board an annual review of the policies, practices and contributions made in fulfillment of the Corporation's social responsibilities. In addition, management shall report annually on its diversity efforts and the results thereof. The Board shall reflect the diversity of the Corporation's shareholders, employees, customers, guests and communities.  

While most corporations note that customers are one of their important stakeholders, Hewlett Packard's (HP's) corporate objectives highlight the customer focus more clearly than do other firms. HP emphasizes loyalty to the customer as the top priority, followed by making a profit and creating value for the shareholders. HP's Corporate Objectives have guided the company in the conduct of its business since 1957, when first written by co-founders Bill Hewlett and Dave Packard. Microsoft notes that selecting board members requires a consideration of many factors. Note, however, that it seeks to recommend for its board a group that can best "represent shareholder interest." Thus, while its board, like Disney's, should have a diversity of experiences, it seeks members who will represent the shareholders, not a diverse group of stakeholders. Microsoft employs a similar approach to HP, noting:

In evaluating the suitability of individual Board members, the Board ... evaluates each individual in the context of the Board as a whole, with the objective of recommending a group that can best perpetuate the success of the Company's business and represent shareholder interests through the exercise of sound judgment, using its diversity of experience.  

Kodak's commitment to corporate governance and to various

stakeholders is reflected in the 2003 publication of its “Corporate Responsibility Principles.” The Principles place importance on high ethical standards, obeying the laws, conducting business activities in an environmentally responsible manner, respecting the privacy rights of its employees, customers and suppliers, and maintaining a philanthropic program. Kodak also brought corporate governance issues into its management structure by appointing, in July 2003, the company’s first chief governance officer. The chief governance officer is responsible for leading the company’s efforts to comply with government and New York Stock Exchange mandates and to identify and adopt best practices in the corporate governance arena. The person is to perform ongoing assessments of the governance practices and structure of the company’s board of directors, and will identify opportunities for improvement. It will be interesting to see if many other companies follow Kodak’s example of assigning a high-level person to specifically look at governance issues. Could the CGO follow the CIO as new executive positions in major firms?

IV. CORPORATE GOVERNANCE IN JAPANESE CORPORATIONS

As of July 1, 2004 approximately 90 companies in Japan have adopted the “Company with Committees” system. After the 2003 shareholders meeting, the first held under the revised Commercial Code, some forty-five companies changed their corporate governance structure by adopting the “Company with Committees” system. While 45 more companies subsequently adopted the new system, most Japanese companies express misgivings about adopting U.S.-style corporate governance and they have not changed their corporate governance structure.

A. Summary of Governance Structure

According to a survey conducted by the Japanese Investor Relations and Investor Support, Inc., the average size of a board at 1,616 firms of the Tokyo Stock Exchange is 11.7. The average at the NIKKEI 225 firms is a little larger, 15.5 as of the end of June 2003. Both figures are comparable to the 12.5 average we found, as of June 2004, for the DJ 30 firms. As for outside directors, the Tokyo Stock Exchange firms average 1.0 outside directors while the NIKKEI 225

average 0.8 outside directors.\textsuperscript{102} Even though firms adopting the new governance system added outside directors to their boards, inside directors still dominate at those firms as well as at all other Japanese firms. In about 75\% of the companies that adopted the “Company with Committees” governance system, the number of inside directors exceeds the number of outside directors.\textsuperscript{103}

**TABLE 3: Major Japanese Firms Where Outside Directors Dominate**

<table>
<thead>
<tr>
<th>Firms</th>
<th>Number of Directors</th>
<th>Outside %</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total</td>
<td>Outside</td>
</tr>
<tr>
<td>JAPANTELECOM HOLDINGS Co., LTD. #1</td>
<td>12 (9)</td>
<td>8 (5)</td>
</tr>
<tr>
<td>JAPAN TELECOM CO., LTD.</td>
<td>9 (10)</td>
<td>6 (7)</td>
</tr>
<tr>
<td>J-PHONE Co., Ltd. #2</td>
<td>9 (8)</td>
<td>6 (4)</td>
</tr>
<tr>
<td>HOYA CORPORATION</td>
<td>8 (8)</td>
<td>5 (5)</td>
</tr>
<tr>
<td>Nomura Securities Co., Ltd.</td>
<td>10 (10)</td>
<td>6 (5)</td>
</tr>
<tr>
<td>Resona Holdings, Inc.</td>
<td>10 (9)</td>
<td>6 (6)</td>
</tr>
<tr>
<td>NOJIMA CORPORATION</td>
<td>10 (11)</td>
<td>6 (6)</td>
</tr>
<tr>
<td>Hitachi Kokusai Electric Inc.</td>
<td>5 (5)</td>
<td>3 (3)</td>
</tr>
<tr>
<td>Resona Bank</td>
<td>11 (9)</td>
<td>6 (6)</td>
</tr>
<tr>
<td>Seiyu, Ltd.</td>
<td>12 (11)</td>
<td>7 (7)</td>
</tr>
</tbody>
</table>

* The 2004 data is shown with ( ) being the number as of July 1, 2004, and is based on the firms’ home pages.

** The 2003 data is based on the list of Companies that moved to “Company with Committees” system, No. 1669 Shozi Homu, (July 2003).

\#1 Vodafone Holdings since December 2003.

\#2 VodafoneK.K. since October 2003.

As noted in Table 3, firms where outside directors are dominant include Hoya Corp., Japan Telecom holdings, Seiyu, Ltd., and Resona


\textsuperscript{103} See The list of Companies that moved to the “Company with Committees” system, No. 1669 Shozi Homu 33 (July 2003), at 33 [hereinafter List of Companies that Moved]. Fifty-five companies, including 14 Nomura Securities group companies, adopted the “Company with Committees” system. Ten of them have boards with a majority of outside directors. Id.
In most cases, the outside directors include a large number of lawyers and academics. Even where there are outside directors, they may not be considered independent. At the June 2004 Hitachi group shareholders meeting, the independence of some outside directors was strictly questioned. Institutional Shareholder Service strongly argued that some of the outside directors would be unable to monitor the firm. Some companies have reacted to the concern with an outside director’s independence. For example, Teijin, although it did not adopt the “Company with Committees” system, requires independence for its outside directors. Independence is defined as not having a material relationship that, in the opinion of the board, would interfere with the exercise of independent judgment.

B. Why have some Corporations adopted the “Company with Committees” governance system?

The reasons why companies have adopted the new system can be classified into four categories. The first category includes companies that are developing their business operations and raising funds globally. Toshiba, Sony, HOYA and Mitsubishi Electric exemplify these companies. The second category includes Japanese firms that are the affiliates of firms based outside Japan. They include Seiyu Ltd., the affiliate of Wal-Mart in the U.S., and Japan Telecom, the affiliate of Vodafone in the U.K. The third category includes companies trying to enhance a group-wide framework to be better able to respond to changing conditions. These firms now seek to operate by establishing a consolidated system rather than through numerous semi-independent units. The Hitachi group and the Nomura group are in this category. Finally, some firms, such as Resona Bank, were forced to adopt the new system in order to receive needed public funding.

The CEOs of the firms that have adopted the new “Company with Committees” system seem pleased with the change, particularly as it relates to outside directors. According to a survey of CEOs from 41 companies that adopted the new system in the first year, almost all (84%) felt that the presence of outside directors enhanced and

104. See Table 3 infra (provides a complete list of the firms having a majority of outside directors).

105. See U.S. Style Governance at the Second Year, NIKKEI WEEKLY, July 6, 2004, at 15.

106. See Independence, NIKKEI WEEKLY, June 6, 2004 at 3. (According to their definition, three of the ten directors at Teijin would be regarded as independent).
revitalized their boards. A clear majority (63%) also reported quicker
decision-making. Two-thirds of the CEOs report they would also like to
increase the opportunity to discuss items of importance with the outside
directors. Specific examples of firms in each category that have
changed their methods of corporate governance are noted in the
following section.

C. Corporations that have changed to the "Company with Committees"
System

1. Changes made due to the global nature of the firm

Sony Corporation changed its governance system because it has
global business operations and raises capital through global markets.
Sony has a long history of continually modifying its management and
organization structures to better adapt to changing business
environments. When it was listed on the NYSE in 1970, it appointed
two outside directors. In 1991, Sony appointed a non-Japanese as an
outside director and in 1997 it separated the oversight and business
operation functions within the company by reorganizing the Board and
establishing Japan’s first corporate executive officer (“Shikko-yakuin”) system. In 2000, the position of chairman of the board was created
and in 2002, it created an advisory board to enhance board of directors’
discussions with expert outside advice. That same year the distinction in
roles between directors and corporate executive officers was further
clarified by abolishing rank-titles for directors.

Sony not only adopted the “Company with Committees” system in
June 2003, it also introduced internal standards for a separation between
the chairman of the board of directors and representative corporate
executive officers. In addition, it imposed qualifications for board
candidates so as to eliminate conflicts of interest and changed the
composition of the board’s nominating and compensation committees
so that a majority of members on each committee are to be outside
directors. After its June 2003 shareholders meeting, Sony announced

108. Id.
109. SONY CORPORATION, Reforming the Sony Group Management Structure to
110. Id.
111. Id.
112. SONY, supra note 109.
that the total number of directors would be 16 (an increase from 11 in 2002), with 8 being outside directors. Three representative corporate executive officers and five corporate executive officers also served as directors. Despite the changes made by Sony, some critics feel it has not gone far enough. Nikkei Business surveyed asset fund managers from 132 management companies and 67 insurance companies regarding the board ranking of both good and bad firms. Based on responses from 104 managers, Sony ranked as both the sixth best company and the sixth worst. The comments said that Sony’s governance was bad because it neither put importance on shareholders’ value nor provided sufficient disclosure of executive compensation. A fund manager criticized what it called “Sony shock” when a top executive suddenly lowered the earnings estimate shortly after providing a very optimistic forecast. Similarly, although there was a motion at the general meeting of shareholders to disclose executive compensation, it was defeated.

According to Sony’s 2004 annual report, “at the general meeting of shareholders held on June 22, 2004, shareholders elected 16 directors, including 8 outside directors. At the subsequent board of directors meeting, members of three statutory committees and 15 corporate executive officers, including the two representative corporate executive officers, were determined.”

2. Changes made due to firm being a part of non-Japanese based group

In order to enhance the group strategy as an affiliate of Vodafone of the U.K., Japan Telecom (JT) moved to the “Company with Committees” system. As of June 2004, it had 10 directors with 7 from outside the firm. Seiyu also now uses the “Company with Committees” system to enhance its partnership with Wal-Mart. Seiyu’s Board had 12 directors, 7 of whom are from outside in June 2003. Of the firm’s 11 executive officers, 5 were also directors. The size of board was reduced to eleven in June 2004.

114. See id. at 40.
116. See The List of Companies that Moved, supra note 103, at 39.
117. Id.
3. Changes made to have a group-wide system for organizational strategy

Hitachi Limited and the Hitachi Group of companies exemplify firms that have adopted the new governance system so that it and its affiliates can respond more quickly to needed business reorganizations or strategic opportunities. On January 30, 2003, Hitachi Ltd. announced that the Hitachi Group would radically alter its corporate governance structure by adopting a new structure. The key goals for the new system include:

(1) Dramatic improvement in speed of management;
(2) More transparent management practices;
(3) To improve the group companies' management strategy; and
(4) To enhance global management

To achieve these goals, Hitachi has made changes in its corporate governance. For example four non-affiliated individuals, with expertise in corporate management, administration and legal affairs, will become Hitachi directors. The third goal, improvement of the group’s management strategy, brings certain group companies’ directors to Hitachi’s Board for the first time and also moves several Hitachi directors and executive officers to the boards of group companies as outside directors. This will greatly strengthen the oversight system for the entire group. In the June 2003 shareholders meeting of Hitachi Ltd., four outside directors were appointed while 33 board members from the parent, Hitachi Ltd., were elected to the boards of subsidiaries.

4. Changes made due to government requirement and receipt of public funds

Resona Bank was essentially required or pressured into making a change in their corporate governance system. Resona was established in 2002 as Japan’s fifth largest bank by the merger of Osaka-based Daiwa Bank Holdings Inc. and Tokyo-based Asahi Bank. Several analysts described it as a marriage of weaklings. As Resona’s external

119. Id.
120. Id.
121. Id.
122. Id.
auditors decided to apply stricter assessment of the value of deferred tax assets, the bank’s capital ratio declined to around 2%, well below the required 4% level for domestic banks. At the end of March 2003, the Prime Minister and the Financial System Management Council decided to inject 2.3 trillion yen from public funds to eliminate concerns about the bank’s future among depositors, customers, and investors. At the same time, the bank decided to replace old management, inviting directors from outside the group and adopting a “Company with Committees” system to strengthen corporate governance and make its management more transparent. In June 2004, Resona reduced the size of the board from eleven to nine with three directors from inside and six from outside. Before the 2003 and 2004 changes, all 11 directors were from inside.

D. Corporations that created their own system of corporate governance

Two well-known Japanese global firms, Matsushita Electric Industrial Co. Ltd. (MEI) and Toyota Motor Co. (TMC), have each established a corporate governance system that blends features of traditional Japanese governance with U.S.-style governance. Their boards mainly focus on the monitoring function and deciding corporate strategy, while the decision making regarding daily operations is settled by executive officers at operational fronts. These firms are not seeking to completely isolate supervisory functions from execution functions, but instead want both operational and supervisory representatives on the board.

Matsushita Electric Industrial Co., Ltd. implemented a new group management system and established its new corporate governance system on April 23, 2003. Each of MEI’s business domain companies will have autonomous management while an Executive Officer System will be used to integrate the comprehensive strengths of all group companies. The board of directors will elect executive officers, who


125. Id.

126. Resona Bank, supra note 124.


will each serve in that capacity for one year. Executive officers will be equal, in terms of rank and status, to members of the board of directors.

The MEI Board will focus mainly on deciding corporate strategies and monitoring and supervising business domain companies with the responsibilities for execution of business held by Executive Officers. MEI will not change its policy of having management personnel, who are well versed in day-to-day operations, participate in Board of Directors meetings. To strengthen the internal auditing function, full-time Senior Auditors will be placed at MEI internal division companies and a group auditors meeting will promote collaboration with subsidiaries' corporate auditors.

As of June 2004, the number of directors decreased from 27 to 19. Out of 19, six internal directors will have only monitoring responsibilities while the other 11 internal directors will have both monitoring and operational responsibilities. There are two outside directors. "Through these reforms, the board of directors maintains balance in terms of the backgrounds of its members, while reducing the total number of board members. The terms of office for board members has also been shortened to one year to clarify their responsibilities and allow for a more dynamic organization."

TMC's governance system is meant to make the most of its traditional strengths. These include placing at its management core people capable of understanding and putting into practice TMC's corporate principles and of practicing hands-on decision-making (genchi genbutsu—going to an issue's source to understand the actual situation, build consensus and expediently achieve one's goal). At the same time the company partially adopted an U.S.-style system and

129. Panasonic News, supra note 127.
130. Id.
131. Id.
132. Id.
133. Id.
sought to strengthen corporate auditing efforts by increasing the number of outside statutory auditors. The statutory auditors will be increased to seven, four of whom are from outside the company.

The new management system includes several notable changes. Non-board managing officers "will number about 30-40 persons, each in charge of daily operations in specific fields/divisions, and include non-Japanese and younger appointees, as well as executives resident at TMC's overseas affiliates, whose numbers will be increased. Each will be appointed for a one-year term." The new board consists of 27 members, down from 58. All are at the senior managing director rank or higher. The number of non-board managing officers is 44 as of July 1, 2004. This system is different from the typical "Company with Committees" system as Toyota has no outside director on the board and the system is heavily dependent upon the role of senior managing directors responsible for both oversight and operations. "Pursuant to home country practices exemptions granted by the New York Stock Exchange (the 'NYSE'), Toyota Motor Corporation... is permitted to follow certain corporate governance practices complying with Japanese laws, regulations and stock exchange rules in lieu of NYSE's listing standards."

E. Corporations that have not changed their corporate governance

Despite the changes in the Commercial Code, most companies in Japan kept their current corporate governance structure. There is a great deal of opposition to the introduction of outside directors. Criticism to this system amounts to the question: "What do those from the outside know about our company?" The main concern is that such board members would not be capable of properly judging the company's business practices to make an appropriate decision. Another concern is the availability of qualified candidates. According to a Ministry of Finance report, "in Japan there are not many appropriate outside directors and that is one of the big reasons why Japanese companies are reluctant to adopt outside directors."

Table 4 depicts the reasons why: 

136. Toyota Motor Corporation, supra note 135.
137. Id.
138. Id.
140. See Iwao Nakatani et. al., Corporate Governance Reform of Japanese Companies, TOYO KEIZA SHINPOSHA, Feb. 2003, at 268.
141. Japanese Ministry of Finance Policy Research Institute, Progress in Corporate
Japanese firms have not adopted the "Company with Committees" system of governance. The first three responses indicate a general satisfaction with the status quo and a reluctance to change.

TABLE 4: Reasons Why Japanese Firms Have Not Adopted A "Company with Committees" Governance System

<table>
<thead>
<tr>
<th>Reason</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Improvement of efficiency and soundness is possible through current system</td>
<td>44.0%</td>
</tr>
<tr>
<td>Current statutory auditor's system functions well</td>
<td>42.8%</td>
</tr>
<tr>
<td>Current system is well-suited to Japanese society and culture</td>
<td>31.5%</td>
</tr>
<tr>
<td>Improvement of transparency is possible through current system</td>
<td>24.1%</td>
</tr>
<tr>
<td>It is too difficult to have appropriate outside directors</td>
<td>13.4%</td>
</tr>
</tbody>
</table>

* The data is based on the responses of a 5/8/03 survey sent to 995 companies by the Japanese Association of Corporate Auditors. See Report from Ministry of Finance Policy Research Institute, Progress in Corporate Governance Reforms and Revitalization of Japanese Companies (June 2003).

One of the companies that made no changes is Canon Inc. Its President, Mr. Mitarai, strongly defends the current corporate governance structure. He argues that

the existing corporate system under supervision of its auditors works just fine for Canon. At many U.S. companies what outside directors actually do is just listen to corporate executives' explanations about companies, rather than performing their supposed role of supervising management. This is because they have little knowledge about day-to-day operations of companies due to part-time status.\(^\text{142}\)

\(^{142}\) Governance Reforms and Revitalization of Japanese Companies, at 36.

At Canon, there are 28 directors and all are internal. Mr. Mitarai explained that to become a director is a dream of many employees.\textsuperscript{143}

According to a May 2003 survey of 1,194 companies by the Japanese Association of Corporate Auditors, as of that date only 1.3\% of companies actually shifted to the "Company with Committees" system and the number considering a change was only 1.2\%.\textsuperscript{144} Another survey, published in the weekly \textit{Toyo Keizai}, found approximately 1,500 outside directors in publicly listed companies. Of those 1,500 at least 1,000 are either from a firm's large shareholders, main banks, or from companies with which it has a material business relationship.\textsuperscript{145} Thus, even though they are outside directors, they are not independent. These surveys show that most of Japanese companies have so far made no change, despite the Commercial Code revision. Still, the law is having some effect even at those companies; some of them are establishing their own committees for nomination and compensation. Professor Nobuo Nakamura of Waseda University notes, "These new methods will go far in helping conventionally managed corporations improve the effectiveness of corporate governance."\textsuperscript{146} It may be said that Japanese companies are trying to establish their own competitive system, although the progress looks slow.

\textbf{CONCLUSION}

Corporate governance structures in both U.S. and Japanese firms have changed after the Sarbanes-Oxley and Commercial Code legislative reforms, even though, to date, the reforms are taking place in only a small number of Japanese firms. The starkest difference in governance in each country's firms is in the composition of the boards. Almost all Japanese directors are from inside the firm while almost all U.S. directors are from outside the firm. In our view, the choice between inside and outside board members relates to differing views in each country as to the board's primary function—be it establishing

\textsuperscript{143} See Board Ranking in 2003, supra note 113, at 41.

\textsuperscript{144} See The Report of Research, How Companies Moved After the Revision of Commercial Code in 2003, JAPANESE ASSOCIATION OF CORPORATE AUDITORS, May 8, 2003 (According to the survey, 1.3\% of 1,194 companies had actually shifted, 1.2\% were considering a shift to the "Company with Committees" system, 83.5\% companies had no plan to shift and 14.7\% companies, which was 50.8\% in the May 2002 survey, had not decided yet).

\textsuperscript{145} See Do Outside Directors Function Well?, Special Report, WEEKLY TOYO KEIZAI (Oct. 18, 2003), at 110.

\textsuperscript{146} See Nakamura, supra note 52, at 10.
management policies and strategy or monitoring the management. Boards always have, and always will, simultaneously serve both the managerial and monitoring functions. As SEC Commissioner Cynthia Glassman has noted, "we should recognize that there is an undeniable tension between the dual roles of directors as partners with management in running the company on the one hand, and as judges of management’s performance on the other." 147

While the composition of the board differs dramatically in Japan and the United States, the size of the boards are now smaller and comparable, from 10-15, in each country’s firms. 148 As for the critical issue of the independence of board members, most firms in both countries did not measure up. While directors in U.S. firms are usually outsiders, due to their close relationship with the CEO, many of those directors cannot be considered independent. Nevertheless, due to the recent NASDAQ and NYSE rules there is greater use of independent directors in U.S. firms than in Japanese firms. 149 Although Japanese critics rightly note that inside directors generally perform well the strategic oversight and mediating functions, at critical times the role and responsibility of outside independent directors becomes crucial. For example, Professor Bernard S. Black of Stanford Law School discusses the duty of special care of outside directors when a firm is a takeover target. 150 On the other hand, during the recent financial scandals at a number of U.S. firms, many “outside directors” lacked the independence to challenge a CEO’s financial misstatements or self-interest actions. 151 Outside independent directors also need to be provided with necessary, full, timely, and accurate information while employees and managers need access to board members. Reporting of concerns to independent directors or an audit committee, as described in GE’s guidelines, 152 is important to establish an enhanced risk management system.

As Japanese firms move towards different governing systems, their need for board members with independent views will take different forms. As firms that do not move to a “Company with Committees”

147. See Glassman, supra note 22.
148. See Table 1 supra; see also Research by Japan Investor Relations, supra note 102.
149. See discussion supra note 23.
151. See U.S.-Style Corporate Governance?, supra note 142.
system continue to use the statutory auditor to monitor managers’ decisions, the independence of most of the statutory auditors, rather than the independence of a majority of all board members, is critical. For firms that do switch to a “Company with Committees” system, thus giving up the outside statutory auditor and potentially losing any external perspective, it is important that they develop a structure which ensures that effective monitoring will still be performed. Although the law requires a majority of each committee consist of outside directors, it does not require outside directors to constitute a majority of the board.

Several problems with the Commercial Code need to be addressed. The Code defines who are outside directors, but does not require them to be independent. Thus, a board could consist mostly of outside directors who have material relationships with the firm. We recommend the law require firms that move to the “Company with Committees” system include a majority of independent directors on the board. Insiders alone cannot provide the independence and external perspective needed in many such decisions. Another problem is that the Code still allows an outside director to serve on more than one committee. Such a director could be a member of three committees and also have a material relationship or be a good friend of the CEO. Similarly, an outside statutory auditor may have a material relationship, such as being from a firm’s main bank or from a company that has a significant business relationship with a firm. In both cases, independence should be required for those positions.

Boards also need to determine whether to separate the position from the chairman’s position and how to set an adequate, but not exorbitant, level of compensation. Although there is controversy, we conclude that such a separation helps make clear the distinction between the monitoring function, which the chairman is responsible for, and the execution function, which the CEO performs. When the CEO is also chairman of the board, the board is less likely to challenge any of the CEO’s recommendations. As to compensation, in both the U.S. and Japan there seems to be widespread agreement that some CEOs, particularly in the U.S., are paid too much. In 2001, the average CEO compensation in the U.S. was over 411 times the compensation for the average line workers in 2001. By comparison it was 43 times in 1980. Kazuo Inamori, founder and Chairman emeritus of Kyocera argues,

153. See Maeda et al., supra note 66, at 56.
154. See id. at 271.
155. See USA TODAY, Apr. 21, 2003, at 4.
Of course, a leader should be given a certain amount of power and compensation. However, directors, officers, general managers, department heads and tens of thousands of other employees are also working together and producing profit for corporation through their joint efforts. Corporate profit is the fruit of such joint efforts and should be shared with all the people.\footnote{156}{See USA TODAY, supra note 156.}

Finally, other stakeholders are becoming more important to a corporation and their interests also must receive attention. As noted in one corporation’s statement about corporate objectives, corporate laws in the U.S. give directors and officers the flexibility to balance shareholders’ interest against other stakeholders.\footnote{157}{See Hewlett-Packard Company, Corporate Objectives, at http://www.hp.com/hpinfo/abouthp/corpobj.html (last visited Mar. 24, 2005).} Moreover, both in Japan and the United States, environmental and social responsibility are becoming critical issues for corporations and their customers, suppliers, employees and investors. The latest report on corporate governance reform from Japan’s Ministry of Finance’s Policy Research Institute notes that although it is generally considered that corporate governance reforms and management that places priority on employees are in an antagonistic relationship, this is not necessarily the case. The greater the extent to which employees are involved in management at companies under the strong monitoring pressure of capital markets, the more active those firms were toward corporate governance reforms.\footnote{158}{Hideaki Miyajima, Progress in Corporate Governance Reforms and the Revitalization of Japanese Companies, at http://www.rieti.go.jp/en/columns/a01_0097.html (last visited Mar. 24, 2005).}

The Institute’s report also argues, “what was especially interesting here was that firms which maintained long-term employment, while attempting to introduce a merit-based wage system, actively pursued reforms and enjoyed high performance. This combination of long-term employment, merit based wages and active information disclosure can be seen as a model for rejuvenating Japanese companies.”\footnote{159}{See Miyajima, supra note 158.} For both employees and shareholders some blending of Japanese and U.S.
corporate governance systems appears attractive.

An earlier article on the role of boards concluded that "the proper balance between the paradigms of the [b]oard as manager versus monitor will differ depending on a number of company-specific characteristics." We would add that cultural differences also affect the balance. By utilizing their unique cultural and historic strengths, Japanese companies have and will continue to establish their own competitive corporate governance structures, as is true at both Matsushita and Toyota. Investors in both the U.S. and Japan are paying close attention to corporate governance that includes a board performing an effective oversight function. As the legal changes in the U.S. were much more encompassing than those enacted into law in Japan, it is in Japan where further legislation, related to the independence of board members, is required. Japanese firms and investors should demand that the government quickly implement such changes. As to changes by the corporations, although the method of implementation will differ, directors and officers in both U.S. and Japanese companies should adopt and implement an effective and competitive corporate governance system that suits their company's ability to grow and responds to the needs of stakeholders.