The Josai Journal of Business Administration (2005), Vol.2, No.1, 1-16
©2005, Josai University

Corporate Governance in Japan:

Can you see the changes?

William McCarty*

Professor, Western Michigan University

Makoto Toda

President, Nissay Credit Guarantee Company

Abstract

Corporate governance changes in Japan, designed to make corporations more competitive, have the potential to alter long-accepted ways of conducting corporate affairs. The Commercial Code now permit firms to opt for a U.S.-styled "company with committees" governance system. Despite the new option, most firms are keeping the present system where the CEO selects internal executives to sit on the board and statutory auditors serve to monitor the board. Nevertheless, several governance changes are now recognizable. Most firms have reduced the size of their boards and made board appointments reviewable annually. A majority of statutory auditors now must be from outside the firm. Survey and interview results suggest that while the pace of change is slow, a number of firms have added or are searching for outside directors for their boards.

Although fewer than one hundred Japanese firms have opted for the new system, firms that have changed report an improvement in their governance. Four reasons explain why Japanese firms may change to the U.S-style of governance with the global nature of a firm being the most important. The lack of qualified outsiders is the reason most companies cite as to why they are not opting for a new governance system. However, even in those companies, the competitive environment is forcing other changes including the splitting of the CEO and Board Chairman positions, the separation of some monitoring and operational activities, and the use of specialized committees to work with Board members.

While our research supports the use of different governance systems, because most directors are still from inside the company we recommend that Japanese law should require the inclusion of a number of independent directors on the Board. They could bring fresh insights and objectivity whether firms stay with their existing governance structure, make incremental changes to address selected governance concerns or adopt the new Company with Committees system.

Key Words: board of directors, CEO or President, commercial code, company with committee system, corporate governance, corporation, governance system, monitoring, statutory auditors.

Introduction

Overview

Changes in corporate governance are occurring across the globe and Japan's changes, designed to make corporations more competitive, have the potential to alter long-accepted

* Professor McCarty was a Fulbright scholar lecturer in Japan during the fall of 2004.

ways of conducting corporate affairs. A 2003 change in the Japanese Commercial Code provides firms with three governance options, including the formation of a Company with Committees system modeled on the governance structures found in most U.S. firms. Although to date only a small percentage of Japanese firms are selecting this new system, change is occurring and firms that have changed generally are positive about their new system. At the same time, the strength of cultural-based components in corporate governance structures is diminishing.

A major difference in U.S. and Japanese boards is that in Japanese firms most board members are also corporate executives. That structure, of course, makes effective monitoring of executives by the board impossible. In the past, Japanese boards have also tended to be significantly larger than those in the U.S. However, the attention given to corporate governance has led to both a reduction in the size of Japanese boards and a small, but noticeable increase in the number of outside board members. As in the United States, the CEO is often dominant in selecting board members.

This article examines the governance options available in Japan, with emphasis on the new Company with Committees system, and suggests reasons why firms either are changing or deciding not to do so. Change comes slow to Japan and allowing firms to opt to retain their current governance system does accommodate special needs and historical corporate cultural concerns. A number of firms that are keeping their existing governance system are also seeking to improve board oversight and decision-making. Although the new options improve the outlook for more effective corporate governance, specific additions to the Commercial Code are needed to obtain clearer oversight by corporate boards. Greater use of independent directors and auditors and the separation of the CEO and Chairman roles would enhance corporate governance.

Reasons for Changes

The primary reason for governance reform was that government and some business leaders believed that Japan, Inc. must enhance its business operational and organizational structures to remain competitive with U.S., European and Chinese firms (Shiseki, 2002). A second agent for reform was the dramatic change in the composition of shareholders. While banks and other stable customer or supplier firms that owned and were owned by *keiretsu* partner firms once were dominant shareholders, in recent years institutional funds and individual investors have grown in influence. With cross-shareholding clearly diminishing,[1] many Japanese firms no longer can count on shareholders whose concerns were focused more on long-term business relationships than on the return on their investments. Instead, they now must react to institutional and foreign investors whose concerns focus on corporate profitability and the return on investment.

Finally, as in the United States, a number of corporate scandals diminished investor trust in Japan, Inc. Scandals affected such well-known enterprises as Yukijirushi, Nippon Meat Packer, Tokyo Electric, and Mitsubishi Motors in the past few years. At Yukijirushi, because the management did not know how to react to a major food poisoning scandal, the firm went bankrupt. Executives were forced to resign due to the mislabeling of beef at Nippon Meat Packers and false inspection data was used to conceal problems at nuclear power plants operated by Tokyo Electric while Mitsubishi Motors was caught in covering up decades of cus-

1 Fumiaki Kuroki, *The Relationship of Companies and Banks as Cross-Shareholdings unwind — Fiscal 2002 Cross-Shareholding Survey,* NISSAY RESEARCH INSTITUTE available at: http://www.nliresearch.co.jp/eng/research_int.html. The value of stock held in cross-shareholding has delined from 18.4% in 1987 to 7.4% in 2002.

tomer complaints about defective vehicles.

The 2003 Commercial Code revision sought to create a more competitive corporate governance system so as to revitalize Japanese corporations. 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 (Gilson and Milhaupt, 2004). 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. Under the previous law, a firm's Board of Directors, traditionally composed of firm managers, was responsible for both the supervision and execution of operations. The distinction between monitoring and operating didn't exist. As a result of the change in the law, even firms that are not changing their governance system are separating some monitoring and operational activities.[2]

Factors Affecting Corporate Governance in Japan

Corporate governance in firms is affected not only by internal factors, but also by the external environment in which firms operate (Chew and Gillan, 2005). Internal factors include an emphasis on the development of harmony among corporate employees which leads to a different decision-making process, the hiring of employees for life-long employment which affects the willingness to invest in human capital, and the promotion of senior executives to service as both executives and board members. The external environment that most directly affects Japanese corporate governance development is the role that banks have played in corporate governance and the existence of cross-shareholding among members of the same corporate group or keiretsu. The lost decade of the nineteen nineties brought changes in these forces causing government and business leaders to more closely examine the corporate structure.

A major internal factor that affects the governance system is the decision-making process. Japanese corporations usually follow the philosophy of "ringiseido" (Alon, 2003). This participative process that occurs at various levels is considered to stimulate group harmony and to provide a feeling of involvement. While it takes patience to work through the process, those who participate in the "ringi" process see it as their responsibility to implement the decision. The strength of communication and mutual understanding among multiple levels of management plays 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.

In most Japanese firms, almost all directors are appointed or, to be more exact, promoted internally. Lifelong employment and the promotion of executives to directors has produced strong loyalty to the firm because becoming a director is a dream for many employees. However, it often produces loyalty to the CEO rather than to the firm and because there is no external monitoring of CEOS by independent directors or auditors, the CEOs power can become excessive. As these directors are also executives or managers, there is no clear distinction between the management of operations and the monitoring of executives who are responsible for the management. Executives as directors face conflicts on both personnel and budgetary issues as operationally they represent and advocate for one part of the organization whereas as a director they need to look out for the interest of the entire firm.

As for external factors, two major cultural elements stand out as affecting Japanese

2 Matsushita and Toyota are two such firms; their changes are discussed later in this article.

corporate governance: the central role of a main bank in providing funds, management expertise and even governance oversight to firms and the existence of cross-shareholding among keiretsu members. As banks were key shareholders of many firms, they frequently served as external monitors 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 officers (Okabe, 2203 and Sheard, 1989). 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 pure outsiders' check system. It is quite an irony that who 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.[3]

Also unique to Japan is the "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. In the 1960s cross shareholding was used to prevent stock acquisition by foreign companies and in the 1980s cross shareholding aggressively promoted large volume equity financing. Cross-shareholding brings stable management to firms 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 (Kubori, 2003).

Both internal and external influences on governance have changed. Globalization 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. Due to bad loan problems, bank financing has been gradually replaced by fund procurement in capital markets, thus diminishing the main bank's influence on corporate governance. Similarly, as stock 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.[4]

As a result of these 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, the sourcing and methods of operations as well as the attraction of needed capital have to be more in line with global standards. Firms looking for global recognition, markets and capital are expected to eliminate corporate scandals and to attain better performance through an enhanced corporate governance structure. In matters specifically related to corporate governance, the Japanese government found that the U.S. system operated as a *de facto* global standard (Katsu, 1998).

---

3 Ryuji Konishi, *Japanese Bank's Failure,* Remarks at Asian Conference in Harvard Business School (Feb. 6, 1999).

4 *See* Kuroki, *supra* note 1.

Legal Changes Affecting Corporate Governance

The Beginning of Corporate Governance Reform

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: "Nowadays, just one inappropriate act by an on-site employee can destroy a brand name and ruin a company. The 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."[5]

Another important aspect of corporate governance is to attain better performance. Professor Takeaki Kariya of Meiji University says that if companies do not take reasonable risks, better performance (return) cannot be created. He concludes "No uncertainty, no need for management"[6] 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. Although statutory auditors are used in several countries, their role is often not well understood. The statutory auditor's function is to monitor the legal conformity of business conducted by directors (J-IRIS Research Newsletter, 2002). Outside statutory auditors in Japan are usually executives of other companies, people from a firm's main bank, its lawyers, or people with which the firm has continuing business relationships. Generally, a firm uses both inside and outside statutory auditors, but the Commercial Code now requires a majority of the auditors to be from outside the firm.

The 2001 Code revisions also require that a resigning auditor be granted the right to state his or her opinions at the shareholders meeting and extend the term of service for auditors from three to four years.[7] 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. All firms not opting for the new Company with Committee Governance system must make these auditor-related changes at the first shareholders' meeting occurring after May 1, 2005 (Nakamura, 2003).

The 2003 Revisions in the Japanese Commercial Code

Japanese boards appear to be similar to those in the U.S. Elected by shareholders (and thus responsible to them), they set overall corporate policies and direction, and appoint and monitor the company executives who implement these policies. The reality, however, is that as the members of the Board are all from inside the firm, the interests of the employees as a group is paramount in the Board's decision-making. The Code acknowledges the dual role of board members who perform both oversight and operational functions. According to Commercial Code Sec. 260 (1), "The board of directors decides the operation of a company and monitors the execution of directors." It is this weakness in the governance system that the

5 Hideaki Kubori, *Shacho no Ketsudan ga Kaisha wo Mamoru* [*The decision of a CEO protects a corporation*], Nihon Keizai Shinbunsha 35 (2003).

6 Kariya, Takeaki, *Fudosan Kinnyukogaku towa nanika?* [What is the financial engineering about real estate?] Toyo Keizai Shimposha (2003), 17.

7 Commercial Code secs. 273 (1) and 274 (1).

2003 revisions in the Commercial Code addressed — at least in part. Those revisions give 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.[8]

For companies electing the first choice, the only changes in the decision-making of the Board are those that have been noted regarding 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.[9] Although to date only Honda has adopted this system, more companies likely will do so. Honda said it adopted this system "to ensure proactive decision-making... related to the disposal of the Company's important assets"[10]

If the third choice is elected, the three committees and the representative corporate officer system replace the conventional statutory auditor system. Toshiba Corporation captures the possible benefits of the new governance system. "Under the previous Commercial Code, the board of 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."[11] As the Toshiba comment 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.

Governance under the Company with Committees System

Toshiba explained its adoption of the new governance system "as a means of enhancing corporate governance by reinforcing supervisory functions and management transparency and improving operating agility and flexibility."[12] 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 is perhaps the most important of the three committees. It monitors both the appropriateness and the legal conformity of business carried out by both directors and executive officers. The audit committee also prepares a proposal for the election and removal of external auditors that must be approved by the shareholders. Audit committee members may not serve as executive officers or employees of the company or any subsidiary.[13] However, no provision bars keiretsu member representatives or others who have a material rela-

---

8 The Japanese Law for Special Exceptions to the Commercial Code concerning Audits, etc. of Corporations, sec. 1-2-(3).

9 The Japanese Law for Special Exceptions to the Commercial Code, sec. 1-3-(3).

10 Honda Motor Co., *Management Organization,* available at <http://world.honoa.com/investors/finnacial results/2004/2003_2nd/25.html.>

11 Toshiba Corporation, *Toshiba to adopt Company with Committees System,* (January 29, 2003) available at <http://www.toshiba.co.jp/about/press/2003_01/or2903.html>

12 *See* Toshiba, *supra* note 11.

13 The Japanese Law for Special Exceptions to the Commercial Code, sec. 21-8-(7).

tionship with a firm from being on the audit committee.

The function of the nominating committee is limited. It determines the content of proposals pertaining to the election and removal of directors at shareholders meeting. However, the board of directors, not the nominating committee, retains the right to elect and remove members of the committees. The compensation committee determines the compensation for each director and executive officer. At least three board members are to be on each of the three committees and the majority of each committee must be outside directors. Company executives may serve as members of the nominating or compensation committee, but not of the auditing committee. Committee members cannot be regarding 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 (Maeda, 2003).

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.[14] 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.[15]

Corporate Governance Changes

Overall response

While several distinct governance changes are occurring at Japanese corporations, the pace and breadth of change is quite slow. One area in which significant change has occurred concerns the size of the Board of Directors. According to a survey conducted by the Japanese Investor Relations and Investor Support, Inc., the average Board size at 1616 firms of the Tokyo Stock Exchange is now 11.7. The average at the NIKKEI 225 firms is a little larger, 15.5 as of the end of June 2003 (Japanese Investor Relations Survey, 2004). Both figures are comparable to the 12.5 average we found as of June 2004 for the U.S.'s DJ 30 firms. By comparison, the average number of board members among 300 large firms was 20.7 in 1999 (NIKKEI Survey, 2002). As for adding outside directors, a number of firms are searching for candidates, but most firms still have almost all inside directors. Firms listed on the Tokyo Stock Exchange currently average 1.0 outside directors while the NIKKEI 225 firms average 0.8 outside directors. 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 seventy-five percent of the companies that adopted the "Company with Committees" governance system, the number of inside directors exceeds the number of

14 Commercial Code, sec. 188-(2)-7-2.

15 Both the NASDAQ and NYSE rules now require a majority of a publicly traded corporation's board to be independent, but they differ slightly as to how to determine independence. The NYSE looks at whether a person has a material relationship with the company while NASDAQ looks at whether the person can exercise independent judgment. The rules can be found in the SEC Notice of November 4, 2003, 68 FR 64154.

outside directors.[16]

As noted in Table 1, outside directors dominate at only a few firms including Hoya Corp., Japan Telecom companies, Seiyu, Ltd, and Resona Bank. 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 (NIKKEI, July 6, 2004).

Table 1 Major Japanese Firms Where Outside Directors Dominate

Firms	Number of Directors		Outside %
	Total	Outside	
JAPANTELECOM HOLDINGS Co., LTD. #1	12 (9)	8 (5)	67% (56%)
JAPAN TELECOM CO., LTD.	9 (10)	6 (7)	67% (70%)
J-PHONE Co., Ltd. #2	9 (8)	6 (4)	67% (50%)
HOYA CORPORATION	8 (8)	5 (5)	63% (63%)
Nomura Securities Co., Ltd.	10 (10)	6 (5)	60% (50%)
Resona Holdings, Inc.	10 (9)	6 (6)	60% (67%)
NOJIMA CORPORATION	10 (11)	6 (6)	60% (55%)
Hitachi Kokusai Electric Inc.	5 (5)	3 (3)	60% (60%)
Resona Bank	11(11)	6 (6)	55% (55%)
Seiyu, Ltd.	12 (11)	7 (7)	58% (64%)

Both the 2003 and 2004 data are shown with numbers as of July 1, 2004 shown in parentheses.
The 2003 data is based on the list of Companies that moved to “the Company with Committees” system, No. 1669 Shozi Homu (July 2003).
The 2004 data is based on the firms’ home pages.
#1 Vodafone Holdings since December 2003.
#2 Vodafone K.K. since October 2003.

Based on our survey of Nikkei 225 CEOs and selected follow-up interviews, it appears that a number of companies are planning to add outside directors who would be considered to be independent (Nikkei 225 Survey, 2004). 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 (NIKKEI, JUNE 30, 2004).

As for changing to a new governance system, as of July 1, 2004 only about 90 firms had adopted the “Company with Committees” system (NIKKEI, AUGUST 22, 2004). After the 2003 shareholders meeting, the first held under the revised Commercial Code, some forty-five companies changed to 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. Although they are appointing fewer directors and enhancing the role of operational executives, they want to retain the dominance of inside directors that exists under their current corporate governance structure.

16 *The list of Companies that moved to the Company with Committees system.* No. 1669 Shozi Homu (July, 2003), 33. Ten of the 55 companies that had moved to the new system during 2003 had a majority of outside directors.

Why do firms adopt the "Company with Committees" governance system?

The reasons why companies have adopted the new system can be classified into four categories as noted in Table 2. 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 of U.S., and Japan Telecom, the affiliate of Vodafone of 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. In order to receive the funding, the bank adopted the "Company with Committees" governance system.

Table 2 Reasons Why Japanese Firms have Adopted a Company with Committees Governance System

Reason	Sample Firm
1. Global Nature of Business	Toshiba, Sony
2. Affiliate of Non-Japanese Firm	Seiyu, Japan Telecom
3. Demands of Groupwide Business	Hitachi, Nomura
4. Demands Due to Receipt of Public Funds	Resona Bank

The CEOs of the firms that have adopted the new Company with Committee 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 revitalized their boards. A clear majority (63%) also reported quicker decision-making. Two-thirds of the CEOs report they'd also like to increase the opportunity to discuss items of importance with the outside directors (NIKKEI, June 26, 2004). Specific examples of firms in each category that have changed their methods of corporate governance are noted in the following section.

Changes made due to global nature of 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 modified its management and organization structures to better adapt to changing business environments. In 1970, it appointed two outside directors when it listed on the NYSE and in 1991 it added a non-Japanese outside director. In 2000, the position of Chairman of the Board was created and in 2002 rank-titles for directors were abolished so as to clarify the distinction in roles between directors and officers.[17] 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 outside directors.

After its June 2003 shareholders meeting, Sony announced that the total number of directors would be 16 (an increase from 11 in 2002), with 8 being outside directors. Despite

17 Sony Corporation, *Reforming the Sony Group Management Structure to Strengthen Corporate Governance,* available at <http://www.sony.net?SonyInfo/News/Press/200301/03004E/>

the many 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 one. 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 motion at the shareholder's meeting to disclose executive compensation was defeated (NIKKEI BUSINESS, 2004).

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

In order to enhance the group strategy as an affiliate of Vodafon of 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. In June 2003, Seiyu's Board had 12 directors, 7 of whom were from outside. As of June 2004, six of 11 directors were from outside the firm.[18]

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 made several changes in its corporate governance. For example four non-affiliated individuals, with expertise in corporate management, administration and legal affairs, are now 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. In the June 2003 shareholders meeting of Hitachi Ltd., four outside directors were appointed while 33 board members from Hitachi Ltd. were elected to boards of subsidiaries.[19]

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 them as a marriage of weaklings (CLARINET, 2003). 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.

Toyota's (TMC) governance system is meant to make the most of TMC's 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, building

18 The list of Companies that moved to the Company with Committees system. No. 1669 Shozi Homu (July, 2003), 3.

19 Hitachi, Ltd., *Reinforcing Corporate Governance,* available at <http://www/hitachi.com/New/cnews/E/2003/0130a/index.html>

consensus and expediently achieving one's goal). At the same time the company partially adopted an U.S.-style system and sought to strengthen corporate auditing efforts by increasing the number of outside statutory auditors managing directors."[20]

Why are firms not changing their corporate governance system?

There are two related concerns. The first is whether those from outside the company would be capable of judging the company's business practices while the second is whether there are a sufficient number of qualified candidates. While such responses appear somewhat parochial, they do raise important considerations. Outside directors do need to spend a significant amount of time to keep abreast of a firm's activities and in most cases, the obvious candidates are already very busy with their own business or professional activities. 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."[21] Table 3 depicts the reasons why Japanese firms have not adopted the Committee with committees system of governance. The first three responses indicate a general satisfaction with the status quo and a reluctance to change.

Table 3 Reasons Why Japanese Firms have Not Adopted a Company with Committees Governance System

Reason	%
Improvement of efficiency and soundness is possible through current system	44.0%
Current statutory auditor's system functions well	42.8%
Current system is well-suited to Japanese society and culture	31.5%
Improvement of transparency is possible through current system	24.1%
It is too difficult to have appropriate outside directors	13.4%

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 (June 2003), *Progress in Corporate Governance Reforms and Revitalization of Japanese Companies*"

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 US 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."[22] At Canon, there are 28 directors and all are internal. Mr. Mitarai explained that to become a director is a dream of many employees.

According to a May, 2003 survey of 1194 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 that was considering a change was only 1.2% (Japanese Association of Corporate Auditors, 2003). Another survey, published in the weekly *Toyo Keizai,* (Weekly Toyo Keizai, 2003) 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 relation-

20 Toyota Motor Corporation, Toyota to Introduce New Management System, Streamlined Board, available at <http://www.toyota.co.jp/jp/news/03/Mar/nt03_0310.htm39>

21 *Progress in Corporate Governance Reforms and Revitalization of Japanese Companies,* Report from Ministry of Finance Policy Research Institute (June, 2003), 3-6-2, See Table C at 36.

22 *U.S.-style corporate governance?* THE NIKKEI WEEKLY (June 30, 2003), 9.

ship. 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 in their governance system, despite the Commercial Code revision.

Still, the law is having some effect even at those companies as 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."[23] It may be said that Japanese companies are trying to establish their own competitive system, although the progress looks slow.

Conclusion

Corporate governance structures in Japanese firms are changing after the Commercial Code legislative reforms even though to date reforms are taking place in only a small number of firms. One of the most noticeable changes occurring in almost all Japanese boards is that their size has shrunk dramatically-with most boards numbering less than 15 members as compared with more than 20 in 1999. This change bodes well for board deliberations. Few would argue that more meaningful questions and discussions can occur with a smaller board than where dozens of representative officers meet.

As to the composition of board members, almost all Japanese directors are still from inside the firm while in contrast almost all U.S. directors are from outside the firm. In our view, the inside vs. outside board members relates to the view in each country as to the board's primary function, be it establishing management policies and strategy (Japan) or monitoring the management (U.S.). 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."[24]

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 (Black, 2001). 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 (Nikkei Weekly, 2003). Several firms such as Mitsubishi Corp. and NEC are seeking to enhance their internal controls and risk management system by ensuring that employees can report concerns to independent directors, outside consultants or to an Audit Committee.

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 system" continue to use the statutory auditor to "monitor" man agers' decisions, the independence of most of the statutory auditors becomes critical. In

23 Nakamura, Noburo, (2003) *Corporate Governance in Japan: Today and Tomorrow,* Japan Economic Currents, No. 34, July, 10.

24 Glassman Cynthia, *Board Independence and the Evolving Role of Directors,* Speech at 26th Annual Conference on Securities Regulation and Business Law Problems available at <http://www.sec.gov.speechspch022004cag.htm>

addition, adding even a few outside members to the Board is likely to change the deliberations for the better (Nikkei 225 Survey, 2004). 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 to ensure that effective monitoring will still be performed. Although the law requires a majority of each committee to consist of outside directors, but 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 (Maeda, 2003). 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. Almost half of the 49 respondents to our Nikkei 225 Survey indicated they separate these positions and we find that trend encouraging. 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. However, the important issue is to separate the function of the monitoring and the execution. As the Chairman in most Japanese firms is the former President or CEO, the needed independence and external check is not perfect in this system.

Finally, other stakeholders are becoming more important to a corporation and their interests also must receive attention. Academics may be too concerned with conflicts among stakeholders as Japanese executives we interviewed felt their diverse needs could be balanced without great difficulty (Nikkei 225 Survey, 2004). Similarly, a recent 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 a management priority on employees are in an antagonistic relationship, this is not necessary 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" (Miyajima, 2003). 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." (Miyajima, 2003).

An earlier article on the role of boards concluded that "the proper balance between the paradigms of the Board as manager versus monitor will differ depending on a number of company-specific characteristics" (Fish, 1997). 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. Japanese investors are paying close attention to corporate governance that includes a Board performing an effective oversight function. The external governance environment should change to require each major corporation to add some independent members to the board of directors. Both Japanese firms and investors should demand that the government quickly implement such a change. Internally, we do not advocate any one change that should affect all corporations. Nevertheless, while the method of implementation will differ, directors and officers in Japanese companies have the responsibility to adopt and implement an effective and competitive corporate governance system that best suits their company's ability to grow and to respond to the needs of their stakeholders.

References

Aalon, Iilan Alon,（2003）*Japanese Corporate Management in Transition,* INSIGHTS No. 1, 3:3.

Black, Bernard S.（2001）*The Core Fiduciary duties of Outside Directors,* ASIA BUSINESS LAW REVIEW. 3.

Chew Jr, Donald H. and Gillia, Stuart L.（2005）*Corporate Governance at the Crossroads,* New York: McGraw-Hill/Irwin.

Clarinet, 2003, *Japanese bank Resona to cut 4,000 jobs,* Oct. 29, available at <http://quickstart.clari.net/qs_se/webnews/wed/an?Qjapan-banking-resona.RT-y_DOU.html.>

Fish, Jill E.,（1997）*Taking Boards Seriously,* CARDOZO LAW REVIEW 19, 265.

Gilson, Ronald and Milhaupt, Curtis J.,（2004）*Choice as Regulatory Reform: The Case of Japanese Corporate Governance*（*April 2004*）. Columbia Law and Economics Working Paper No. 255 Stanford Law and Economics Glin Working Paper No. 282; ECGI-Law Working Paper No. 22/2004.

Japanese Association of Corporate Auditors,（2003）*How Companies moved after the revision of the Commercial Code in 2003,* Report of Research, May 08.

Japanese Corporate Governance, Columbia Law and Economics Working Paper No. 251; Stanford Law and Economics Olin Working Paper No. 282, 17.

Japanese Investor Relations and Investor Support Survey,（2004）NIHON KEIZAI SHINBUN（Nikkei）August 22, 1.

J-IRIS Research Newsletter（2002）, Issue 2, 4.

Kariya, Takeaki,（2003）*Fudosan Kinnyukogaku towa nanika?*［What is the financial engineering about real estate?］Toyo Keizai Shimposa, 17.

Katsu, Etsuko（1998）*Global Capital Revolution,* Toyo Keizai Shinposha, 14, 21, 25.

Kubori, Hideaki（2003）Shacho no Ketsudan ga kaisha wo Mamoru［The decision of a CEO protects a corporation］, Nihon Keizai Shinbunsha 35.

Kuroki, Fumiaka（2002）The Relationship of Companies and Banks as Cross-Shareholdings unwind － Fiscal 2002 Cross-Shareholding Survey, NISSAY RESEARCH INSTITUTE available at <http://www/nliresearch.co.jp/eng/research_ind.html.>

Maeda, Hiroshi, et. al.（2003）, *Corporate Governance Kaikaki No Zitsumu*［*Corporate governance practices under the revised commercial code*］NIHON KEIZAI SHINBUNSHA, 2003, 236.

Miyajima, Hideaki（2003）, *Progress in Corporate governance Reforms and the Revitalization of Japanese Companies,* Report from Ministry of Finance Policy Research Institute（June）, 3-6-2, available at <http://ww.rieti.gp.jp.en/columns/a01_0097.html>

Nakamura, Noburo,（2003）Corporate Governance in Japan: Today and Tomorrow, JAPAN ECONOMIC CURRENTS, No. 34, July, 6.

NIKKEI,（June 20, 2002）*Survey,* NIHON KEIZAI SHINBUSHA, 2002, 3.

NIKKEI,（June 26, 2004）*Survey,* NIHON KEIZAI SHINBUNSHA, 6 & 10.

NIKKEI,（June 30, 2004）*Independence,* NIHON KEIZAI SHINBUNSHA, 3.

NIKKEI,（July 6, 2004）*U.S. Style governance at the second year,* NIHON KEIZAI SHINBUNSHA 15.

NIKKEI,（August 22, 2004）NIHON KEIZAI SHINBUNSHA, 1.

NIKKEI BUSINESS,（2004）*Board Rankings in 2003*（January 12）, 39.

NIKKEI WEEKLY,（2003）*U.S.-style corporate governance?*（June 30）, 9.

Nikkei 225 Survey（2004）Survey responses were received from nearly 50 firms and interviews were conducted with representatives of Mitsubishi, Mitsui-Sumitomo Bank, NEC, Nippon Life and Sumitomo Trust Bank.

Okabe, Mitsuaki,（2003）CROSS SHAREHOLDINGS IN JAPAN, 37.

Sheard, Paul,（1989）*The Main Bank system and Corporate Monitoring and Control in Japan,* Journal of

Economic Behavior & Organization. 11: 399-402.
Shiseki, Masamitsu (2002) *2002 Revision of Commercial Code of Japan,* BANKING LAW JOURNAL, 1658, 64.
Weekly Toyo Keizai (October 18, 2003) *Do outside directors function well?,* Special Report, 110.