CORPORATE GOVERNANCE OF BANKING ORGANIZATIONS IN THE UNITED STATES AND IN JAPAN

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ABSTRACT

Bank regulators have been aware of the importance of sound corporate governance practices of banking organizations, and have recognized themselves as stakeholders. The Basel Committee on Banking Supervision, whose membership includes Japanese and American bank regulators, issued "Enhancing Corporate Governance for Banking Organisations" in 1999. Both Japan and the United States, however, have been slow in making legislation, regulations or guidelines for banking organizations based on "Enhancing Corporate Governance for Banking Organisations." In 2002, both countries enacted new corporate governance laws. Although these laws are applicable to all businesses, they can be helpful to bank regulators by urging banking organizations to promote sound corporate governance and improve their bank supervision function. When bank regulators make new regulations and guidelines regarding banking organizations' corporate governance, they should make sure that "Enhancing Corporate Governance for Banking Organisations" is reflected in them.

I. RECOGNITION OF THE IMPORTANCE OF SOUND CORPORATE GOVERNANCE

The term "corporate governance" refers to "two separate, but not unrelated, conditions: accountability to the public for the impact of corporate functioning on society and accountability to the owners for the effective management of assets."[1]

It is crucial that banks have strong corporate governance because:

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[1]ROBERT A.G. MONKS & NELL MINOW, CORPORATE GOVERNANCE 284 (2d ed. 2001).

> [b]anks are a critical component of any economy. They provide financing for commercial enterprises, basic financial services to a broad segment of the population and access to payments systems. In addition, some banks are expected to make credit and liquidity available in difficult market conditions. The importance of banks to national economies is underscored by the fact that banking is virtually universally a regulated industry and that banks have access to government safety nets.[2]

The importance of banks to national economies requires them to be accountable to the public. A bank's access to government safety nets such as deposit insurance and injection of public money makes the government, in a sense, a potential owner. This gives rise to governmental interest in the accountability of the banks.[3] Bank regulators have recognized that sound corporate governance must exist for bank supervision to function well.[4]

Based on such recognition, an international banking standard on corporate governance has been formed as one of the international banking standards that have been initiated by Basel Committee on Banking Supervision.[5] Global unification in banking regulation has been promoted by worldwide financial corruption and fears about ensuing political unrest in the financial services industry.[6] As a part of such global convergence in banking regulation, the formation of what is known today as Basel Committee on Banking Supervision, which includes both Japan and the

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[2]Basel Comm. on Banking Supervision, *Enhancing Corporate Governance for Banking Organisations* 3 (Sept. 1999), *at* http//www.bis.org/publ/bcbsc138.pdf.

[3]The question is which aspect we should emphasize: necessity of the banks to be accountable to the public (namely depositors) due to the importance of banks to national economies, or the governmental interest in the accountability of the banks based on the bank's access to government safety nets. The author's opinion is that it is better to emphasize the latter, because accountability to the owners is the most common usage of the term corporate governance, and because by equating the government with the shareholders in ordinary companies, it may be easier to analogize the corporate governance of banking organizations with the preexisting corporate governance theories such as fiduciary duty of the board of directors to shareholders.

See also Patricia A. McCoy, *A Political Economy of the Business Judgment Rule in Banking: Implications for Corporate Law*, 47 CASE W. RES. L. REV. 1, 68-79 (1996) (discussing the notion of the importance of banks to national economies).

[4]Basel Comm., *supra* note 2, at 1.

[5]*Id.*

[6]Patricia A. McCoy, *Musings on the Seeming Inevitability of Global Convergence in Banking Law*, 7 CONN. INS. L.J. 433, 436 (2000-2001).

U.S. as its members, has been backed up by the Bank of International Settlements in Basel, Switzerland.[7]

The Basel Committee issued "Enhancing Corporate Governance for Banking Organisations" in September 1999.[8] The paper highlighted several sound corporate governance practices:

- "Establishing strategic objectives and a set of corporate values that are communicated throughout the banking organisation";[9]
- "Setting and enforcing clear lines of responsibility and accountability throughout the organisation";[10]
- "Ensuring that board members are qualified for their positions, have a clear understanding of their role in corporate governance and are not subject to undue influence from management or outside concerns";[11]
- "Ensuring that there is appropriate oversight by senior management";[12]
- "Effectively utilizing the work conducted by internal and external auditors, in recognition of the important control function they provide";[13]
- "Ensuring that compensation approaches are consistent with the bank's ethical values, objectives, strategy and control environment";[14] and
- "Conducting corporate governance in a transparent manner."[15]

Bank regulators of most countries, however, usually prefer to adopt banking standards informally and behind the scenes. Once the G-10 creates and endorses a set of standards, they can be adopted by executive decree or

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[7]*Id.* at 437. *See also* Steven L. Schwarcz, *Private Ordering*, 97 NW. U.L. REV. 319, 325-26 (2002) (explaining further the nature of banking standards issued by Basel Committee).

[8]Basel Comm., *supra* note 2. The Bank of Japan, the Financial Supervisory Agency of Japan, the Federal Reserve Board, the Federal Deposit Insurance Corporation, and the Office of Comptroller of Currency were members of the Risk Management Group of the Basel Committee at that time. *Id.*

[9]*Id.* at 5.

[10]*Id.*

[11]*Id.* at 6.

[12]Basel Comm., *supra* note 2, at 7.

[13]*Id.*

[14]*Id.* at 8.

[15]*Id.*

agency order in many countries, without statutory enactment.[16] Both Japan and the United States have been slow in passing banking legislation, regulations, guidelines, or even executive decree or agency order based on "Enhancing Corporate Governance for Banking Organisations."

II DIFFERENCES BETWEEN AMERICAN AND JAPANESE BANK REGULATORS

A. *Bank Regulators in the United States*

In the United States, there are many regulative authorities.[17] The Comptroller of the Currency is the appropriate federal banking agency for national banks, district banks, and foreign banks.[18] State member insured banks and bank holding companies and their nonbank subsidiaries are regulated by the Federal Reserve System's Board of Governors (FRB).[19] The FRB may also act in that capacity for foreign banks[20] and lending companies.[21] The Federal Deposit Insurance Corporation (FDIC) is the corresponding federal banking agency only for the nonmember state insured and foreign banks.[22] Additionally, state-chartered banks are regulated by state banking regulators.[23]

Fragmented banking and diversity among banking regulators in the U.S. can "be seen as resulting from two primary forces, popular dislike of large money center banks and the political power of the small country

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[16]McCoy, *supra* note 6, at 445-46.

[17]MATTHEW BENDER & COMPANY, BANKING LAW MANUAL § 13.03 (LEXISNEXIS 2002).

[18]*Id.* § 13.03[2] (citing 12 U.S.C. § 1813(q)(1) (2000)).

[19]*Id.* (citing 12 U.S.C. §§ 1813(q)(2)(A), (F) (2000)).

[20]*Id.* (citing 12 U.S.C. §§ 1813(q)(2)(B)-(C), (E) (2000)). These sections respectively designate the Federal Reserve as the appropriate federal banking agency for the following entities:

(1) any branch or agency of a foreign bank with respect to any provision of the Federal Reserve Act which is applicable under the International Banking Act of 1978 (12 U.S.C.A. §§ 3101 *et seq.*);

(2) any foreign bank which does not operate an insured branch; and

(3) supervisory or regulatory proceedings arising from the authority given to the Board of Governors under section 7(c)(1) of the International Banking Act of 1978, 12 U.S.C.A. § 3105(c)(1), including such proceedings under the Financial Institutions Supervisory Act of 1966.

Id. § 1303[2] n.53.

[21]BANKING LAW MANUAL, *supra* note 17 (citing 12 U.S.C. § 1813(q)(2)(B) (2000)).

[22]*Id.* (citing 12 U.S.C. § 1813(q)(3) (2000)).

[23]*See* PAULINE B. HELLER & MELANIE L. FEIN, FEDERAL BANK HOLDING COMPANY LAW § 1.02[5], at 1-7 (rev. ed. 2002).

banks."[24] The American preference that power is dispersed among institutions exemplifies the first,[25] while Congress's federal organization's preference for powerful small-town bankers exemplifies the second.[26]

B. *Bank Regulators in Japan*

In Japan, the Ministry of Finance (MOF) used to manage every aspect of fiscal and financial administration. The situation changed, however, with problems of housing loan companies (jyusen), many of which were subsidiaries or affiliated companies of banks. The money that the banks loaned to jyusen during the period of economic "bubble" turned into huge amounts of non-performing loans. Most jyusen failed, and public money was used to settle many of the debts incurred. Because the MOF was in charge of both fiscal and financial administration, it was criticized when it resorted to the convenience of using fiscal expenditures to settle the jyusen problem it caused by its earlier maladministration of financial policy.[27]

Furthermore, once the people of Japan heard that banks such as Daiichi Kangyo Bank were bribing MOF inspectors with entertainment, they could no longer trust the effectiveness of MOF bank inspections. Bank employees called "MOF Tan"[28] entertained MOF inspectors at geisha parties, in exchange for dates of inspection and the names of the branches that would be inspected.[29]

These incidents led to the separation of the financial supervisory and inspection function from the MOF, and the transfer of that function to the Financial Supervisory Agency, which was established in June 1998.[30] Furthermore, in June 2000, the Financial Supervisory Agency and the Financial System Planning Bureau of the MOF merged and became the

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[24]MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE 97 (1994).

[25]*Id.* at 28.

[26]*Id.* at 55.

[27]Oue Ueno, *Ookura Kaikaku Nashini Gyokaku ha Nai—Mondou: Zaisei to Kinyu no Bunri [No Administrative Reform without MOF Reform—Questions and Answers to Separation of Finance]*, MAINICHI SHINBUN, Sept. 9, 1999, *available at* http://www.mainichi.co.jp/eye/feature/article/digital/09/09_9.html.

[28] "Tan" is Japanese for "person in charge of."

[29]*Tokuho—Deguchinaki Seikan no Fuhai [Special Report—No Exit for Corruption of Politicians and Bureaucrats]*, SHUKAN POST, Jan. 23, 1998, *available at* http://www.weeklypost.com/jp/980123jp/news/news_6.html.

[30]Ueno, *supra* note 27.

Financial Services Agency (FSA).[31] Today, the FSA is the sole administrative body that supervises and inspects private-sector financial institutions, including banks.[32]

III. RECENT CORPORATE GOVERNANCE FOR BANKING ORGANIZATIONS IN THE UNITED STATES

Over a decade ago, weak corporate governance of banking organizations in the United States was an issue. "Fraud and high risk real estate transactions jeopardized the health of the banking industry," and Congress responded with new supervisory standards such as the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA).[33] Except for the largest banks and bank holding companies (such as those listed on the New York Stock Exchange[34]), corporate governance has not been an issue for at least ten years in the United States.[35]

The understanding of bank directors was that there had been no statutory or bank regulatory compulsion for their boards to adopt any particular governance practices.[36] The bank regulators often shied away

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[31]FIN. SERVS. AGENCY, FINANCIAL SERVICES AGENCY 3 (English ed. 2002), *available at* http://www.fsa.go.jp/info/infoe/pamphlet_e.pdf.

[32]*Id.* at 4.

[33]Christopher J. Zinski & Mark R. Pacioni, *The Sarbanes-Oxley Act of 2002: Financial Institution Compliance*, 120 BANKING L.J. 191, 191 (2003).

[34]The New York Stock Exchange has its own corporate governance rules. *See* New York Stock Exch. Communications Div., *Accountability Report Sets Higher Bar*, 9 THE EXCHANGE 1, 2 (June 2002), *available at* http://www.nyse.com/pdfs/xn1v9n06.pdf.

[35]Jeffrey Gerrish, *10 Commandments for Community Bank Corporate Governance*, S.W. GRADUATE SCHOOL OF BANKING FOUND. NEWSLETTER (SWGSB, Dallas, Tex.) (2002), *at* http:www.swgsb.org/Alumni/Jeffrey_Gerrish.htm.

[36]David H. Baris, *What Can Bank Directors Learn from Recent Corporate Scandals?* AMERICAN ASSN. OF BANK DIRECTORS ARTICLES (AABD, Bethesda, MD) Jan. 24, 2003, *available at* http://www.aabd.org/news/articles/corporatescandals.html.

It should be noted that an Office of the Comptroller of the Currency (OCC) regulation provides that:

> To the extent not inconsistent with applicable Federal banking statutes or regulations, or bank safety and soundness, a national bank may elect to follow the corporate governance procedures of the law of the state in which the main office of the bank is located, the law of the state in which the holding company of the bank is incorporated, the Delaware General Corporation Law, Del. Code Ann. Tit. 8 (1991, as amended 1994, and as amended thereafter), or the Model Business Corporation Act (1984, as amended 1994, and as amended thereafter). A national bank shall designate in its bylaws the body of law selected for its corporate governance procedures.

12 C.F.R. § 7.2000(b) (2002). National banks have had the option of following the corporate governance procedure of Model Business Corporation Act (MBCA) other than following that of

from getting involved in corporate governance issues. For example, the FRB has refused to consider matters relating only to corporate governance in application procedures for acquiring or forming a bank holding company.[37]

One of the reasons why corporate governance was a "non-issue" for most banks and bank holding companies in the United States may have been because "[b]ankers were powerful local figures. With some minimal organizational effort, they became powerful political forces."[38] Additionally, large amounts of public money has not been injected into American banks as it has in Japan recently.[39]

A. *Federal Banking Law Provisions*

There have been some federal banking law provisions that can affect the corporate governance of banks and bank holding companies. These provisions, however, were not created specifically to establish sound corporate governance practices.[40]

1. Bank Holding Company Act (BHC Act)

> Under Section 5 of the BHC Act, as amended by [the Gramm-Leach-Bliley Act,] the [FRB] may require a bank holding company and any subsidiary thereof to submit reports under oath to keep the FRB informed as to:
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> - the company's financial condition, systems for monitoring and controlling financial and operating risks, and transaction with depository institution subsidiaries; and

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the state laws. The corporate governance procedures of MBCA and state laws were generally very simple compared to that of the Sarbanes-Oxley Act.

[37]*E.g.*, C-B-G, Inc, 85 Fed. Res. Bull. 335, 336 n.8 (1999); Valley View Bancshares, Inc, 85 Fed. Res. Bull. 64, 65 n.3 (1999); New Prague Bancshares, Inc., 83 Fed. Res. Bull. 909, 910 n.4 (1997).

[38]ROE, *supra* note 24, at 97.

[39]*See* John D. Cornet, *Bank Governance: An Independent Director's Perspective*, 7 N.C. BANKING INST. 1, 5 (2003) (stating that the industry has been doing well since the 1980 bank crisis).

[40]*See id.* at 1.

- compliance . . . with . . . the BHC Act or any other federal law that the [FRB] has [the authority] to enforce.[41]

The FRB requires bank holding companies to file a number of reports, such as the annual report,[42] which utilizes form FR Y-6.[43] The FRB could have required bank holding companies to report its corporate governance system as a system for monitoring and controlling financial operating risks. Except for the list of each principle shareholder, director, trustee, partner, and executive officer, however, information regarding corporate governance systems has not been required in the FR Y-6 form.[44]

> Section 5 of the BHC Act also authorizes the FRB to examine each bank holding company and each subsidiary thereof for the following purposes:
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> - to inform the [FRB] of the nature of the operations and financial condition of the holding company and its subsidiaries;
> - to inform the [FRB] of the financial and operational risks within the holding company system that may pose a threat to the safety and soundness of any depository institution subsidiary of the holding company and the systems for monitoring and controlling such risks; and
> - to monitor compliance with the BHC Act and any other federal law that the [FRB] has specific jurisdiction to enforce and those governing transactions and relationships between any depository institution subsidiary and its affiliates.[45]

Safety and soundness examinations evaluate management capability and adequacy of internal controls. Federal Reserve supervisory personnel

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[41]HELLER & FEIN, *supra* note 23, § 5.03, at 5-6.2 (citing Bank Holding Company Act, 12 U.S.C. § 1844 (2000), *amended by* Gramm-Leach-Bliley Act, Pub. L. No. 106-102 (1999)).

[42]12 C.F.R. § 225.5(b) (2002).

[43]*See* Annual Report of Bank Holding Companies, Form FR Y-6, ONB No. 7100-0124, *available at* http://www.federalreserve.gov/boarddocs/reportforms/reportdetail.cfm.

[44]Instructions for Preparation of Annual Report of Bank Holding Companies, Reporting Form FR Y-6, at GEN-5 (reissued Dec. 2001), *available at* http://www.federalreserve.gov/boarddocs/reportdetail.cfm.

[45]HELLER & FEIN, *supra* note 23, § 5.04, at 5-8.3 (citing Bank Holding Company Act, 12 U.S.C. § 1844 (2000), *amended by* Gramm-Leach-Bliley Act, Pub. L. No. 106-102 (1999)).

follow manuals such as the Bank Holding Company Supervision Manual[46] and the Commercial Bank Examination Manual[47] in conducting such examinations. These manuals inform banking organizations of the systems they are required to have for the purpose of securing safety and soundness. They also function as guidance to banking organizations. At the conclusion of a federal examination, the examiners will prepare a report of examination.[48] If examiners find deficiencies, they will direct the institution's board of directors to make specific changes or improvements.[49]

2. Federal Reserve Act

Federal laws do not prohibit loans by banks and thrifts to their directors, officers, or their related interests. The Federal Reserve Act,[50] as implemented by Regulation O,[51] however, places quantitative limits on such loans and prohibits insider loans on preferential terms.[52]

3. Federal Deposit Insurance Corporation Improvement Act

The "FDICIA established a system of 'prompt corrective actions' as a means of enhancing the supervisory powers of the federal banking agencies."[53] There are four specific corrective actions that may be relevant to corporate banking governance. The first prohibits an insured depository institution from paying its management personnel if, as a result, the institution would fail to meet the required minimum level for any relevant

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[46]DIV. OF BANKING SUPERVISION & REG., BANK HOLDING COMPANY SUPERVISION MANUAL § 1000.0 at 1 (Bd .of Governors of the Fed. Reserve System, June 2001), *available at* http://www.federalreserve.gov/boarddocs/supmanual/bhc/bhc1202.pdf.

[47]DIV. OF BANKING SUPERVISION & REG., COMMERCIAL BANK EXAMINATION MANUAL (Bd. of Governors of the Fed. Reserve System, 4th ed. Mar. 1994), *available at* http://www.federalreserve.gov/boarddocs/supmanual/cbem/0211cbem.pdf.

[48]*See, e.g.*, 12 U.S.C. §§ 481, 1820(b)(6)(B) (2000).

[49]*See, e.g.*, 12 U.S.C. § 481(2000); 12 C.F.R. §§ 5.34(d)(3), 30.3, 30.4(a)(2), 263.302, 263.303(a)(2), 308.302, 308.303(a)(2), 570.2, 570.3(a)(2) (2002).

[50]12 U.S.C. §§ 375, 375b (2000).

[51]12 C.F.R. § 215 (2002).

[52]12 U.S.C. §§ 375, 375b (2000).

[53]FDIC Improvement Act, Pub. L. No. 102-242 (FDICIA) (1991) (codified as amended at 12 U.S.C. § 1831o (2000)); HELLER & FEIN *supra* note 23, § 5.09, at 5-28 (citing FDIC Improvement Act, Pub. L. No. 102-242 (1991) (codified as amended at 12 U.S.C. § 1831o (2000)).

capital measure. In other words, this prohibition prevents under-capitalization.[54]

The second requires an undercapitalized institution to specify: (1) the steps it will take to become "adequately capitalized," (2) the levels of capital that it intends to reach, and (3) the details of any other activities of the institution. These specifications must be submitted as a "capital restoration plan."[55] The third action reprimands those undercapitalized institutions that fail to submit a capital restoration plan by dismissing old and employing new directors, and regulating capital distributions by the parent holding company.[56] Finally, a receiver for the institution must be appointed within ninety (90) days of it becoming "critically undercapitalized."[57]

4. Federal Deposit Insurance Act (FDIA)

Section 36 of the FDIA, as amended by the FDICIA, applies to insured depository institutions which have at least $500 million in assets and requires that an institution prepare an annual report containing a statement of management's responsibility for establishing and maintaining an adequate internal control structure and an assessment of the effectiveness of internal controls for financial reporting.[58] For example, Section 363 of the FDIC regulation, which implements Section 36 of FDIA, details the content required in the internal control report. It also requires all members of an insured depository institution's audit committee be independent outside directors, and specifies the rights and duties of an audit committee, such as engaging independent counsel and other advisors.[59] Smaller banks with less than $500 million in assets and their holding companies are exempt from such requirements.

Section 8 of the FDIA[60] "sets forth a series of devices the [FDIC] may use in enforcing fiduciary, safety and soundness, and legal standards on banks and their officials."[61] The FDIC is given the power to terminate

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[54]HELLER & FEIN, *supra* note 23, § 5.09[2][b], at 5-28-9 (citing 12 U.S.C. § 1831o(d)(2) (2000)).

[55]*Id.* § 5.09[2][c], at 5-29 (citing 12 U.S.C. § 1831o(e)(2) (2000)).

[56]*Id.* § 5.09[2][k], at 5-30.1 (citing 12 U.S.C. § 1831o(f)(2)(F) (2000)).

[57]HELLER & FEIN, *supra* note 23, § 5.09[2][p], at 5-31 (citing 12 U.S.C. § 1830o(h)(3)(A) (2000)).

[58]12 U.S.C. § 1831m (2000).

[59]12 C.F.R. pt. 363 (2002).

[60]12 U.S.C. § 1818 (2000).

[61]STANLEY I. LANGBEIN & STEVEN I. GLOVER, FINANCIAL INSTITUTION ACQUISITIONS AND ALLIANCES § 7.03[1], at 7-28 (2001).

the deposit insurance of an institution if the conduct of banks and of their officers, directors, and other institution-affiliated parties poses a significant safety and soundness concern.[62] Deposit insurance may also be terminated if the FDIC makes a finding that the directors or trustees of an institution have engaged in unsafe or unsound practices or have violated any applicable FDIC law, regulation, order, condition, or written agreement.[63] It is contemplated the FDIC has "authority to determine a practice 'unsafe and unsound' even if it does not violate a specific law, regulation, or order."[64]

Although termination of insurance is the classic remedy available under the deposit insurance laws, it is among the "most cumbersome."[65] Therefore, Section 8 of the FDIA also includes "more flexible devices" ranging from suspension orders against individuals, to agreements between regulatory bodies and banking institutions, with cease and desist orders and civil money penalties as the middle ground.[66]

For the same reasons Section 8 grants the FDIC power to terminate the deposit insurance of an institution, it also grants the FDIC the power to remove a party of an institution from office or prohibit the party from participating in the affairs of the institution.[67]

The same action can be taken if the party breaches its fiduciary duty,[68] and

> *if* as a result the institution suffered or will probably suffer financial loss or other damage, or the interests of depositors have been or could be prejudiced, or the party reaped financial or other benefit, *all provided that* the party was personally dishonest or demonstrated willful or continuing disregard for the safety or soundness of the institution.[69]

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[62] *Id.*

[63] LANGBEIN & GLOVER, *supra* note 61, § 7.03[2][a], at 7-29 (citing 12 U.S.C. § 1818(a)(2)(A) (2000)).

[64] LANGBEIN & GLOVER, *supra* note 61, § 7.03[2][a], at 7-29.

[65] *Id.* § 7.03[1], at 7-28.

[66] *Id.* Breach of agreements may be the basis for termination of insurance. *See infra* Part IV.A.4.

[67] LANGBEIN & GLOVER, *supra* note 61, § 7.03[4][a], at 7-33; 12 U.S.C. § 1818(e)(1)(A)(i), (ii) (2000).

[68] HELLER & FEIN, *supra* note 23, § 5.10[2][e], at 5-35; 12 U.S.C. § 1818(e)(1)(A)(iii) (2000).

[69] HELLER & FEIN, *supra* note 23, § 5.10[2][e], at 5-35.

The existing decisional law regarding breach of fiduciary duty is interpreted to give the regulatory bodies "power to define independent fiduciary duty as a matter of Federal law."[70]

If the party is engaged in unsound corporate governance practices, and the finding is affirmed, the agency will be able to remove that party. Considering the severity of removal, however, "unsafe or unsound" should be construed narrowly.

B. *Treatment of "Enhancing Corporate Governance for Banking Organisations"*

The FRB has mentioned the Basel Committee's "Enhancing Corporate Governance for Banking Organisations," and encouraged banks and bank holding companies to put into place sound corporate governance practices.

The Federal Reserve Bank of New York hosted a conference entitled, "The Rise and Effectiveness of Corporate Governance Standards" on December 12, 2000. "The express purpose of the seminar was to 'raise the standards of corporate governance in the institutions [the Fed] supervise[s].'"[71] Vanessa Wondra, an examiner of the Federal Reserve Bank of Cleveland Supervision and Regulation Department, in the January 2001 Newsletter, introduced the sound corporate governance practices of financial institutions listed in "Enhancing Corporate Governance for Banking Organisations," and emphasized that "[f]inancial institutions are expected to implement organizational structures that include appropriate checks and balances."[72]

"Enhancing Corporate Governance for Banking Organisations," however, was not incorporated into bank legislations, regulations or guidelines. It seems that American bank regulators were still trying to implement sound corporate governance practices behind the scenes.

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[70]LANGBEIN & GLOVER, *supra* note 61, § 7.03[4][a], at 7-34.

[71]Donald T. Vangel, The Evolving Foreign Bank Supervision Program: A Study in Convergence 11, Presentation given at the Inst. of Int'l Bankers Annual Washington Conference (Mar. 2001), *at* http://www.lib.org/vangel.ppt.

[72]Vanessa Wondra, *Corporate Governance Promotes Collaboration Between Management, Regulators*, 2 FOURTH DISTRICT CONDITIONS No. 1 (Fed. Res. Bank of Cleveland Supervision & Reg. Dep't, Cleveland, Ohio, Jan. 2001), *available at* http://www.clevelandfed.org/bsr/conditions/v2n1/governance.htm.

IV. RECENT CORPORATE GOVERNANCE FOR BANKING ORGANIZATIONS IN JAPAN

A. *Corporate Governance Practices of Japanese Banking Organizations*

The Japanese financial system was heavily controlled and regulated by the MOF until recently. The MOF's goal was to maintain the status quo in the Japanese financial system that was built up during the years of steep economic growth after World War II. This approach was known as the convoy-fleet approach. As a means of accomplishing that goal, the MOF arranged mergers of de factor insolvent banks with healthy banks.[73] The MOF maintained such policy throughout the bubble era in the 1980s during which the economy expanded like cotton candy.

After the bubble burst in the early 1990s, however, the financial situation of financial institutions deteriorated so much that the MOF could not continue with the convoy-fleet approach. In 1998 and 1999, the government poured approximately 10 trillion Yen of public funds into major banks to help strengthen their capital bases.[74] In that process, the Deposit Insurance Corporation of Japan (DICJ) expanded its role and spent more than 22 trillion Yen to cope with the failed institutions by March 2002.[75] As a result, "the government became the most important *de facto* shareholders of those banks,"[76] and should therefore be particularly interested in sound corporate governance. The corporate governance of

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[73]Akiyoshi Horiuchi, A Bank Crisis in a Bank-Centered Financial System—The Japanese Experience since the 1990s, at 19, Paper presented at the Int'l Financial Symposium, *Overcoming Financial Crisis: Financial Reform in Asia* (rev. ed., Oct. 2002), *at* http://www.kdic.or.kr/english/annual_report/files/2002_1_1(session1).doc.

[74]*Id.* at 1-2. The 1998 injections of public money into the banks were based on Kinyu Kinô no anteika no Tameno Kinkyu Sochi ni Kansuru Hôritsu [Law concerning Emergency Measures for Stabilization of the functions of the Financial system], Law No. 5 of 1998, *as amended, available at* http://www.ron.gr.jp/law/law/kinyu_an.htm (this law was abolished on October 16 of the same year) The 1999 injections into the banks were based on Kinyu Kinô no Sôki Kenzenka no Tameno Kinkyu Sochi ni Kansuru Hôritsu [Law Concerning Emergency Measures for Early Strengthening of the Functions of the Financial System], Law No. 143 of 1998, *as amended, available at* http://www.ron.gr.jp/law/law/kinyo_sk.htm. Under Paragraph 1 of Article 5 of the latter law, the rescued banks are required to submit to FSA the Business Revitalization Plan which describes the bank's plans regarding measures for management rationalization, measures for establishing a responsible management system, measures to prevent outflow of profits by dividend payments, etc., measures to secure financial resources allowing for the cancellation, repurchase of stocks issues, and redemption or repayment of loans using profits, and measures to secure soundness of financial conditions and healthy and appropriate operation of business.

[75]*Id.* at 19-20.

[76]*Id.*

banks, however, hardly improved having received public funds.[77] The following corporate governance practices of Japanese banking organizations have been criticized.

1. Government Motivation

The Japanese government has been indifferent to increasing shareholder value.[78] For example, the government has made little effort to sell the bank stocks it holds to private investors.[79] In fact, it is widely predicted that the government will redeem public funds by allowing the banks to buy back their own shares.[80] Moreover, Japanese policymakers did not allow rescued banks to do their business freely as pure private companies and pressed them to provide liquidity to small or midsized enterprises.[81]

2. Management and Shareholder Responsibility

The issue of management and shareholder responsibility of the rescued banks has not been pursued.[82] The Japanese government has not strongly pressed for the resignation of the management of rescued banks or for the existing shareholders of such banks to suffer loss, except in cases of outright nationalization of the Long-Term Credit Bank of Japan, Limited (presently Shinsei Bank, Limited) and the Nippon Credit Bank, Ltd. (presently Aozora Bank, Ltd.).[83]

3. Board Structure

Within Japanese banks, the incumbent management usually nominates the board candidates, and shareholders seldom, if ever, reject them.[84] Outside board members have only a minor presence in Japanese banks, and over half of them are non-standing auditors, while all standing

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[77]Takamasa Yamaoka, *Corporate Governance Underpins Divergent Fortunes of Japanese, Korean Banks*, RatingsDirect, *reprinted in* STANDARD & POOR'S (Oct. 14, 2002) *at* http://www.standardandpoors.com/europe/francais/Fr_resource_center/Articles_Resource_Center/Corporate-Governance_Japan-Korean_14-10-02.html.

[78]*Id.*

[79]*Id.*

[80]*Id.*

[81]Yamaoka, *supra* note 77.

[82]*Id.*

[83]*Id.*

[84]*Id.*

auditors are former employees of such banks.[85] Additionally, outside directors often come from domestic industrial and insurance companies that historically had close business relationships with the banks.[86]

B. *Differences Between the FSA and the MOF That Affect Corporate Governance of Banking Organizations*

The Commissioner of the FSA has authority to inspect banks or bank holding companies and to request reports from them "for the purpose of securing sound and proper operation of the bank's business."[87] The Commissioner may also order the bank to submit reformation plans for securing sound business practices within the bank, and give supervisory orders to take necessary measures, such as ceasing all or part of the bank's business as deemed appropriate.[88]

Before the formation of the FSA, the MOF had the above-mentioned powers. The following characteristics, however, are exclusive to the FSA, and also affect corporate governance of banking organizations.

1. Inspection

The FSA has created the following inspection manuals: (1) the inspection manual for deposit-taking institutions; (2) the supplement to the financial inspection manual: treatment of classifications regarding credit to small and medium-sized enterprises; (3) the inspection manual for insurance companies; (4) the inspection manual for securities companies, (5) the inspection manual for investment trust management companies and investment advisory services;[89] and (6) the inspection manual for financial holding companies.[90] These are guidebooks for inspectors of the Inspection Bureau that summarize "the fundamental principles of inspections and specific points of focus in bank inspections."[91]

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[85]Yamaoka, *supra* note 77.

[86]*Id.*

[87]Ginkô Hô [Banking Law], Law No. 59 of 1981, *as amended*, arts. 24, 25, 52-31, 52-32, 59, *available at* http://www.houko.com/00/01/S56/059.htm.

[88]*Id.* art. 26.

[89]FIN. SERVS. AGENCY, *supra* note 31, at 12.

[90]FIN. SERVS. AGENCY, KIN-YU MOCHIKABU KAISHA NI KAKARU KENSA MANUAL [INSPECTION MANUAL FOR FINANCIAL HOLDING COMPANY] (July 2003), *at* http://www.fsa.go.jp/manual/manual/motikabu.pdf.

[91]FIN. SERVS. AGENCY, *supra* note 31, at 12; "Framework for Internal Control Systems in Banking Organizations" issued by Basel Committee in Sept. 1998 was the model for the FSA inspection manuals. Asahi & Co., *Business Key Word Kinyu Kensa Manual [Financial*

Inspectors are not required to apply the inspection manual in a mechanical or undifferentiated way, but to take into consideration the size and nature of the financial institution. Even if a financial institution is using a measure that is different from what is stated in the manual, it will still be acceptable if the measure ensures the safety and soundness of the financial institution's business, has the same effect as to what is stated in the manual, and is sufficient for a financial institution of that size and nature.[92]

2. Supervision

The Supervision Bureau of the FSA monitors sound and proper business operations, and requests reports on risk-related data of financial institutions, such as the market-related risk of trading accounts.[93] Endorsing the policy of financial supervision, the FSA has totally abolished the informal administrative guidelines, previously used by the MOF. Internal directives have since been issued within administrative organizations and are publicized as "operational guidelines."[94] Such operational guidelines include points that the FSA will focus on when deciding whether to require a bank to submit reports to give supervisory orders such as business improvement administrative orders or to take prompt corrective action.[95]

C. *Differences Between the FDIC of the United States and DICJ*

Unlike the FDIC of the United States, the DICJ plays a very limited role in ensuring the safety and soundness of banking organizations. The DICJ may conduct on-site inspections of financial institutions, however, the scope of its on-site inspections is extremely narrow and is limited to: (1) ensuring proper payment of insurance premiums; (2) ensuring appropriate measures have been taken to prepare databases and to improve information

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Inspection Manual] (2003), *at* http://www.asahiaudit.or.jp/b_info/keyword/r_fim.html.

[92]FIN. SERVS. AGENCY, YOKIN TÔ UKEIRE KINYU KIKAN NI KAKARU KENSA MANUAL [INSPECTION MANUAL FOR DEPOSIT-TAKING INSTITUTIONS] (Feb. 25, 2003), *at* http://www.fsa.go.jp/manual/manualj/yokin.html. The English translation of the manual is available at http://www.fsa.go.jp/manual/manuale/yokin_e/y00.pdf.

[93]FIN. SERVS. AGENCY, *supra* note 31, at 13.

[94]*Id.*

[95]FIN. SERVS. AGENCY, JIMU GUIDELINE DAI1 BUNSATSU: YOKIN TORIATSUKAI KINYU KIKAN KANKEI [OPERATIONAL GUIDELINE VOL. 1: ON DEPOSIT-TAKING INSTITUTIONS] (Feb. 21, 2003), *at* http://www.fsa.go.jp/guide/guide.html. Focal points include the management executive's business attitude, their business management, and asset management. *Id.*

systems for aggregating deposits held by the same depositors; and (3) ensuring that estimated amounts can be repaid against deposits and other claims when a financial institution has become subject to bankruptcy proceedings.[96]

Furthermore, the DICJ does not have the authority to terminate depository insurance, remove or penalize the affiliated parties, or use more flexible remedies that are available for the FDIC in enforcing safety and soundness, fiduciary, and legal standards on banks and their officials. The DICJ also does not have the authority to require financial institutions to submit reports regarding the conditions of their business and assets.

Because the DICJ lacks the above-mentioned powers, it is not in a position to promote the sound corporate governance practices of banking organizations. Under the Deposit Insurance Law, however, the Commissioner of the FSA has broad authority to inspect reports regarding deposit insurance of banking organizations.[97] The availability of deposit insurance allows the DICJ to be more involved with the inspection and supervision of banking organizations because it becomes necessary for banking organizations to have sound corporate governance. Therefore, the DICJ would be effective in inducing banking organizations to improve their corporate governance.

D. *Treatment of "Enhancing Corporate Governance for Banking Organisations"*

The FSA and Bank of Japan have demonstrated interest in communicating within the banking industry on enhancing corporate governance for banking organizations. They each posted on their respective web pages the Japanese translation of "Enhancing Corporate Governance for Banking Organisations."[98] Yet, it is still unclear how bank regulators intend to incorporate the policies into Japanese banks' corporate governance practice.

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[96]Yokin Hoken Hô [Depository Insurance Law], Law No. 34 of 1971, *as amended*, art. 137, *available at* http://www.ron.gr.jp/law/law/yokin_ho.htm. The English translation of the Deposit Insurance Law is available at http://www.dic.go.jp/english/e_laws/2002.9.10.pdf.

[97]*Id.* arts. 136, 139.

[98]FIN. SERVS. AGENCY, (KARIYAKU) GINKO SOSHIKI NI TOTTE NO CORPORATE GOVERNANCE NO KYÔKA [TRANSLATION OF ENHANCING CORPORATE GOVERNANCE FOR BANKING ORGANIZATIONS] (Sept. 16, 1999), *available at* http://www.fsa.go.jp/p_fsa/inter/bis/bj_010.pdf; Bank of Japan, *(Nihon Ginko Kariyaku) Ginko Soshiki ni Totte no Corporate Governance no Kyôka [Bank of Japan's Translation of Enhancing Corporate Governance for Banking Organizations]* (Sept. 1999), *available at* http://www.boj.or.jp/intl/99/bis9909b.htm.

V. NEW CORPORATE GOVERNANCE LEGISLATION IN THE UNITED STATES

A. *Enactment of the Sarbanes-Oxley Act*

The accounting and financial scandals of 2002, which began with the sudden collapse of the Enron Corporation, prompted Congress to enact the Sarbanes-Oxley Act,[99] which sets forth broad prescriptions for corporate governance.[100]

Sarbanes-Oxley requires: an audit committee comprised exclusively of "independent directors," including a financial expert;[101] executive certification of each quarterly report, annual report, and internal control report;[102] and the creation of the Public Company Accounting Oversight Board.[103] Additionally, Sarbanes-Oxley prohibits loans to officers and directors and strengthens the independence of auditors.[104]

Sarbanes-Oxley applies to "public companies, that is, companies (including banks and bank holding companies) that have a class of securities registered under section 12 of the Securities Exchange Act of 1934 (the 1934 Act), or are otherwise required to file periodic reports (e.g., 10-Ks and 10-Qs) under section 15(d) of the 1934 Act."[105]

The above-mentioned characteristics of Sarbanes-Oxley will enhance corporate governance practices listed in "Enhancing Corporate Governance for Banking Organisations" such as establishing a set of corporate values that are communicated throughout the banking organization, setting and enforcing clear lines of responsibility and accountability, assuring board members' independence from management or outside concerns, utilizing the work conducted by auditors, and conducting corporate governance in a transparent manner.

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[99]Sarbanes-Oxley Act of 2002, 107 Pub . L. No. 204 (July 30, 2002).

[100]Handout from Professor James D. Cox to students of the Securities Regulation Course at Duke University School of Law, at 9-14 (Mar. 2003) (on file with author).

[101]*Id.* (citing Sarbanes-Oxley § 301).

[102]*Id.* (citing Sarbanes-Oxley § 906).

[103]*Id.* (citing Sarbanes-Oxley Title I).

[104]Cox Handout, *supra* note 100, at 9-14 (citing Sarbanes-Oxley § 402(a), Title II).

[105]Richard Spillenkothen, *The Sarbanes-Oxley Act of 2002*, SR LETTER 02-20 (Bd. of Governors of the Fed. Reserve system, Div. of Banking Supervision & Reg.) Oct. 29, 2002 (citing 15 U.S.C. §§ 781, 78o(d) (2000)), *at* http://www.federalreserve.gov/boarddocs/SRLETTERS/2002/sr0220.htm.

B. *Initial Reaction of Bank Regulators*

Corporate governance regulation used to lie within the realm of each state's legislature or of self regulation of stock exchanges. At least one bank regulator, the Office of the Comptroller of the Currency (OCC), showed resistance to Sarbanes-Oxley and the proposed SEC rules. The OCC may have viewed Sarbanes-Oxley as a regulatory invasion by Congress and the SEC, a functional regulator that is in charge of the security industry under Gramm-Leach-Bliley. Comptroller of the Currency John D. Hawke stated that "'[t]ime and time again we have seen legislative or regulatory initiatives adopted that might have been avoided or mitigated if the industry had either some credible program of self-regulation or at least some standards of conduct expressing an industry consensus as to what is acceptable conduct,'" and encouraged the banking industry to move quickly and forcefully to adopt standards of corporate governance prior to government action.[106]

C. *The Reaction of the Banking Industries and the SEC's Response*

Banking industries, especially small community banks, also showed some resistance to federal regulation of corporate governance. For example, the American Association of Bank Directors (AABD) opposed "any rules mandating any formulaic approach to the adoption of the 'correct' corporate governance practices for banks or bank holding companies not otherwise required by law."[107]

Even bankers have sent comments to the SEC in connection with the proposed rules, emphasizing that banking is already highly regulated. The SEC has not answered in the affirmative to most of these comments. Below are examples where bank regulators responded to specific issues instead. These responses show the difficulty of coordination among SEC and the bank regulators.[108]

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[106]News Release, Comptroller of the Currency Adm'r of Nat'l Banks, Comptroller Addresses Corporate Reform for Banks, NR 2002-78 (Oct. 7, 2002), *available at* http://www.occ.treas.gov/ftp/release/2002-78.doc.

[107]Baris, *supra* note 36.

[108]Conversely, the FSA does not face such coordination problems because it is in charge of not only inspection and supervision of private sector financial institutions but also for the establishment of rules for trading in securities market as well as surveillance of rules governing securities market. *See* FIN. SERVS. AGENCY, *supra* note 31, at 4. The author is not implying that the Japanese system is necessarily better. In the American system, various bank regulators undertake multi-layered supervision and inspection, which help support the credibility of the financial capital market. On the other hand, in Japan, because FSA is the sole administrative body that deals with inspection and supervision of private sector financial institutions, political pressure

1. Financial Expert

The AABD,[109] Independent Community Bankers of America (ICBA),[110] and America's Community Bankers (ACB)[111] urged the SEC to expand the definition of "financial expert" in proposed Rule 407.[112] ACB said the narrow definition of "financial expert" will make it difficult for community banks, as well as larger companies, to find qualified candidates willing to serve.[113] The ICBA noted that Congress had passed the FDICIA over a decade ago, and banking regulators have followed it[114] by implementing regulations.[115] Further, bank accounting and auditing functions are already scrutinized by banking regulators as part of regular bank examinations.[116]

The SEC considered the difficulty of finding qualified candidates, and eliminated from Rule 407 the proposed instruction which listed several factors a company's board of directors should consider when evaluating the education and experience of a financial expert candidate.[117] It is unclear whether the SEC considered the already existing bank regulations in making this change.

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and criticism on financial administration tend to concentrate on FSA, which may become obstacles for enforcement of laws and regulations by FSA. E-mail from Hisaei Ito, Professor, Chuo University, to author (May 19, 2003, 17:46:34 EST) (on file with author).

[109]Letter from David Baris, Executive Director, American Association of Bank Directors, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (Dec. 9, 2002), *at* http://www.aabd.org/news/letters/SOX.html.

[110]Letter from C. R. Cloutier, Chairman-Elect, Independent Community Bankers of America, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (Dec. 11, 2002), *at* http://www.icba.org/news_views/cl121102.html.

[111]Letter from Charlotte M. Bahin, Director of Regulatory Affairs, Senior Regulatory Counsel, America's Community Bankers, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (Nov. 27, 2002), *at* http://www.americascommunitybankers.com/ government/ scripts/government_view_comment.asp?ID=785.

[112]*Id.* Baris Letter, *supra* note 109; Cloutier Letter, *supra* note 110.

[113]Bahin Letter, *supra* note 111.

[114]*See* 12 U.S.C. § 1831m (2000).

[115]12 C.F.R. pt. 363 (2002).

[116]Cloutier Letter, *supra* note 110.

[117]U.S. Sec. & Exch. Comm'n, FINAL RULE: DISCLOSURE REQUIRED BY SECTIONS 406 AND 407 OF THE SARBANES-OXLEY ACT OF 2002, RELEASE NOS. 33-8177, 34-472-35 (Jan. 24, 2003), *at* http://www.sec.gov/rules/final/33-8177.htm.

2. Internal Controls

The ACB said the internal control report, assessment and attestation requirement "should mirror the similar banking law requirements imposed by the Federal Deposit Insurance Corporation Improvement Act."[118] The ACB insisted that this should include exempting depository institutions with less than $500 million in assets or their holding companies from the requirements.[119] It further said that larger institutions and their holding companies should be allowed to comply with FDICIA standards, codified at Section 36 of the FDIA and implemented by Part 363 of the FDIC regulations.[120]

The SEC does not exempt FDIC supervised banks with less than $500 million in total assets from the aforementioned requirements, if they are public companies, or subsidiaries of public companies.[121] For insured depository institutions with $500 million or more in total assets, however, the FDIC will review its rules to determine whether covered institutions that are public companies, or subsidiaries of public companies, can use the Sarbanes-Oxley Section 404 report to satisfy Section 36 of the FDIA and Part 363 of the FDIC's regulations once internal control rules have been adopted by the SEC.[122]

3. Loans to Officers and Directors

The F.N.B. Corporation (FNB), a financial services holding company, questioned "whether credit and other banking transactions with directors of parent bank holding companies violate the concepts of independence" of Sarbanes-Oxley and the proposed SEC rules.[123]

The FNB pointed out that Regulation O and other rules and regulations of the bank regulators address all aspects of potential insider abuse and that the complex array of regulatory control is the subject of

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[118]Bahin Letter, *supra* note 111.

[119]*Id.*

[120]*Id.*

[121]Michael J. Zamorski, *Corporate Governance, Audits, and Reporting Requirements*, FINANCIAL INSTITUTION LETTERS, FIL 17-2003 (Fed. Deposit Ins. Corp.), Mar. 5, 2003, *at* http://www.fdic.gov/news/news/financial/2003/fil0317.html.

[122]Michael J. Zamorski, *Applicability of Selected Provisions of the Sarbenes-Oxley Act of 2002 to Insured Insitutions with $500 Million or More in Total Assets*, FINANCIAL INSTITUTION LETTERS, FIL 17b-2003 (Fed. Deposit Ins. Corp.), Mar. 5, 2003, *at* http://www.fdic.gov/news/news/financial/2003/FIL0317b.html.

[123]Letter from William J. Rundorff, Executive Vice President & Chief Legal Officer, F.N.B. Corporation, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (Jan. 31, 2003), *at* http://www.sec.gov/rules/proposed/s70203/wrundorff1.htm.

regular and intense scrutiny from bank examiners. It therefore insisted "that the proposed SEC rules on director independence should follow the policy aspects of Section 402(a)(3) of Sarbanes-Oxley and recognize the statutory exception for federally regulated banking companies."[124]

The FRB anticipates "that loans by an insured depository institution to the directors and executive officers of its publicly traded parent bank holding company will be exempt from the prohibition, but will remain subject to the existing restrictions of Regulation O."[125] The SEC has not yet clarified this point in its rules, but according to the FRB, "[t]he SEC has authority to interpret the scope of the lending prohibition in section 402 of the [Sarbanes-Oxley] Act and may issue guidance in the future concerning the scope of the lending prohibition and exceptions in section 402."[126]

D. *Utilization of Sarbanes-Oxley Act by Bank Regulators*

Bank regulators such as the FRB and FDIC recognized that Sarbanes-Oxley and the proposed SEC rules are useful to improve sound corporate governance practices of banking organizations as well as their bank supervision function, and are encouraging every institution to implement them. The FRB and FDIC have issued letters about the impact of Sarbanes-Oxley on banks and holding companies, and about the possible modifications to bank regulations and guidance.

1. The FRB

Governor Bies of the FRB stated in a September 2002 speech that:

> [s]ound corporate governance is an essential element of a strong risk-management process. . . . [B]ankers and bank directors . . . have specific responsibilities to manage the risks at . . . financial institutions and effectively oversee the systems of internal controls. Not only are the activities of banks central to credit intermediation, but, in [the U.S.], banks fund their activities in part with federally insured deposits.

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[124] *Id.* It "exempts from the general loan prohibition provisions those credit relationships which are governed by Regulation O of the [FRB]." *Id.*

[125] Spillenkothen, *supra* note 105.

[126] *Id.*

> Those deposits are the lowest-cost source of funds that banks have, specifically because of the government's guarantee.[127]

Governor Bies' remarks mirror those in "Enhancing Corporate Governance for Banking Organisations," namely, that sound corporate governance practices are necessary in banking organizations because of the importance of banks to the national economy. This explains why banks have access to government safety nets.[128] They share a common notion about the stake the government holds in banking organizations' corporate governance.

Governor Bies also stated that "[a]lthough [Sarbanes-Oxley] applies only to institutions that register their shares with the Securities and Exchange Commission, its elements should be considered by virtually all commercial banks and by most other companies of any material size. They could well highlight weaknesses in [such banks and companies] own procedures."[129]

Shortly after Governor Bies' speech, the Division of Banking Supervision and Regulation of the FRB distributed SR Letter 02-20, which summarized the impact of Sarbanes-Oxley on banks and holding companies that are subject to FRB supervision.[130] According to SR Letter 02-20, the supervisory staff of the FRB will monitor Sarbanes-Oxley compliance and provide ongoing regulatory guidance on its requirements.[131]

The letter also noted that "Federal Reserve staff, together with staff of the other federal banking agencies, currently are reviewing existing regulations and guidance to determine whether modifications to these regulations and guidance are appropriate in light of the [Sarbanes-Oxley] Act," and that the federal banking "agencies are working to develop policies for non-public banking organizations [(i.e. banks and holding companies)] that are in accord with the purposes and provisions of the Act."[132]

Further, the FRB, jointly with the OCC and Office of Thrift Supervision, issued SR Letter 03-8 and confirmed that they "do not expect

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[127]Susan S. Bies, Bank Performance and Corporate Governance, Speech before the Pennsylvania Association of Community Bankers (Sept. 28, 2002), *in* 55 BIS REVIEW 1, 3 (2002), *available at* http://www.bis.org/review/r020930c.pdf.

[128]*See* Basel Comm., *supra* note 2, at 3.

[129]Bies, *supra* note 127, at 4.

[130]Spillenkothen, *supra* note 105.

[131]*Id.*; Ralph Davis, *Fed Releases Guidance on Sarbanes-Oxley*, WALLER LANSDEN DORTCH & DAVIS BULLETIN (Waller Lansden Dortch & Davis, Nashville, TN) Nov. 2002, *at* http://www.wallerlaw.com/information_center/pdf/fed_releases.pdf (citing Spillenkothen, *supra* note 105).

[132]Spillenkothen, *supra* note 105; Davis, *supra* note 131.

to take steps to generally apply the board composition, director independence, audit committee, auditor independence and other corporate governance requirements of the Sarbanes-Oxley Act . . . to non-public organizations that are not otherwise subject to [its mandates]."[133] Alternatively, they stated that each banking organization should ensure that the organization's policies and procedures related to corporate governance and accounting policy matters are consistent with applicable laws, regulations, and supervisory guidance regarding each organization's size, operations and resources.[134]

2. The FDIC

Part 335 of the FDIC's regulations on the registration of securities with the FDIC[135] currently incorporates applicable SEC regulations by reference. This section applies to FDIC-supervised banks that are public companies.[136] In a recent letter to insured depository institutions, the FDIC stated that Part 335 may soon require certain amendments.[137]

The FDIC has summarized the applicability of Sarbanes-Oxley to institutions with $500 million or more in total assets (covered institutions).[138] The FDIC is considering possible amendments to Part 363 of its regulations that would extend certain provisions of Sarbanes-Oxley described in its summary to all covered institutions regardless of whether they are public companies or subsidiaries of public companies.[139]

The FDIC has also issued a summary of selected provisions of Sarbanes-Oxley that it believes are relevant to FDIC-supervised banks with less than $500 million in total assets that are not public companies.[140] The sound corporate governance practices detailed in that summary are not mandatory for smaller, non-public institutions; however, the FDIC stated

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[133]Richard Spillenkothen, *Statement on Application of Recent Corporate Governance Initiatives to Non-Public Banking Organizations*, SR LETTER 03-8 (Bd. of Governors of the Fed. Reserve System, Div. of Banking Supervision & Reg., May 5, 2003), *at* http://www.federalreserve.gov/boarddocs/srletters/2003/sr0308.htm.

[134]*Id.*

[135]12 C.F.R. § 335.211 (2002).

[136]Zamorski, *supra* note 121.

[137]*Id.*

[138]*Id.* at 2.

[139]*Id.*

[140]Zamorski, *supra* note 121. "Of the 9,415 FDIC insured institutions, 89% have under $500 million in assets." Cornet, *supra* note 39, at 4.

that it "recommends that each institution consider implementing them to the extent feasible given its size, complexity, and risk profile."[141]

It is still unclear how the FDIC examiners will apply the summarized provisions to small, non-public institutions. The AABD has, in fact, expressed its concern about such ambiguity.[142] For example, the FDIC "encourages" the board of directors of each institution to establish an audit committee and auditor with total independence. The FRB, however, stated in SR Letter 03-8 that it does not expect to take steps to apply these guidelines to non-public organizations.[143] It is the author's opinion that the examiners should not be required to apply the guidance manual in a mechanical way, but that the institutions should be allowed to develop their own guidelines that ensure a sound corporate governance practice for that institution. This would mirror how the FSA's inspection manuals are applied to financial institutions in Japan.[144]

VI. NEW CORPORATE GOVERNANCE GUIDELINES AND LEGISLATION IN JAPAN

A. *Amendment to the Commercial Code*

In Japan, the necessity of corporate governance reform was recognized after many felonious incidents occurred within some major Japanese companies in the 1990s. Among those incidents were huge illegal payoffs to corporate racketeers, window-dressing of financial statements, and managements' involvement in such illegal activities.[145] Also, the prolonged slump of Japanese companies mandated for a corporate governance system that emphasized checks as well as promoting the enhancement of corporate performance.[146]

A quintessential description of the Japanese companies at present is that they are:

> typified by large, unwieldy boards made up from company insiders who are subservient to the will of the company

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[141]Zamorski, *supra* note 121.

[142]Am. Ass'n of Bank Dirs., *FDIC'S Guidance on Sarbanes-Oxley* (2003) *at* http://www.aabd.org/news/special_reports/FDIC%20Guidance%20on%20SOC.htm.

[143]Spillenkothen, *supra* note 133.

[144]*See* FIN. SERVS. AGENCY, *supra* note 92, at 7.

[145]Kinyu Mochikabu Kaisha Kenkyu-kai, *Nihon no Kinyu Mochikabu Kaisha [Financial Holding Companies of Japan]* 149 (2001).

[146]*Id.*

> president. There is little in the way of a split between executive and supervisory functions, as both fundamentally reside with the board and therefore the president. However, there does exist within most companies the post of statutory auditor, whose job it is to monitor both the actions of the board and the internal control and conduct of the company.[147]

New statutory provisions enacted in 2002 and implemented in April 2003 requires large Japanese companies[148] to chose between two forms of administration.[149] They can either utilize an independent outsider among the traditional auditors or they can adopt an American-type system that uses board committees.[150]

Large companies which choose to adopt American-type systems will be able to appoint executive officers (sikkoyaku) and to establish three committees within the board of directors, including a Nomination Committee, a Compensation Committee, and an Audit Committee.[151] The majority of members of each committee should be composed of outside directors. A company adopting the new system will no longer be allowed to have statutory auditors.[152] This new system enables the board of directors to properly delegate substantial management authority such as the issuance of new shares or corporate bonds.[153]

These provisions will enhance the practices listed in "Enhancing Corporate Governance for Banking Organisations," such as setting and

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[147]Andrew Peaple, *Japan's New Commercial Code*, THE DIGEST (Mar. 2003), *available at* http://www.pwcglobal.com/extweb/NewCoWeb.nsf/docid/0786F337896F717F85256CC3004C06C4?OpenDocument.

[148]A large company has over 500 million Yen of equity or over 20 billion Yen of debt. Kabushiki Kaisha no Kansa-tô no Tokurei ni Kansuru Hôritsu [Law for Special Exceptions to the Commercial Code Concerning Audit, Etc.], Law No. 22 of 1974, *as amended* sec. 1-2, *available at* http://www. ron.gr.jp/law/ka_syoho.htm.

[149]Shôhô Oyobi Kabushiki Kaisha no Kansa-tô no Tokurei ni Kansuru Hôritsu no Ichibu wo Kaisei Suru Hôritu [Law for Partial Revisions of the Commercial Code and the Law for Special Exceptions to the Commercial Code Concerning Audit, Etc.]. Law No. 149 of 2001, *as amended* Law No. 44 of 2002, *available at* http://www.ron.gr.jp/law/law/shouho55.htm.

[150]*Id.*, *as amended* sec. 1-2.3.

[151]*Id.* sec. 21-5.1.

[152]*Id.* secs. 21-8.4, 21-5.2.

[153]*See* Ichiro Koide, *Kaisha Kikan no Arikata to Sono Yukue [How the Corporate Organs are and How They Would Be]* (Torikai Sôgô Hôritsu Jimusho) 8 (2002), *at* http://www. torikai.gr.jp/shouhou/governance/1.pdf.

The new provisions in the Commercial Code are similar to the American Law Institute's Principles of Corporate Governance in that they both aim for the separation of monitoring function and executory function. Ito email, *supra* note 108. *See* AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS §§ 3.01-3.02 (1994).

enforcing clear lines of responsibility and accountability, ensuring the board member's qualifications and independence from management or outside concerns, and utilizing the work conducted by auditors.

Similar reform has stimulated improvements in banks' board rooms. For example, when Mizuho Holdings, the largest financial holding company in Japan, was formed in 2000, it did not have any outside directors.[154] Mizuho Holdings has since added an outside director to its board, and stated in its "Mizuho Change & Speed-up Program," issued in 2002, that it plans to add more outside directors to the organization.[155] Additionally, Risona Holdings, Inc., in June 2003 had 1.96 trillion Yen of public money injected into its subsidiary bank, Risona Bank, Ltd. in exchange for the issuance of preferred shares and common shares in the bank to the Japanese government under Article 102.1 Item (1) of the Deposit Insurance Law. Risona Holdings, Inc. has adopted the American-style system to increase the transparency of its management.[156] Risona Holdings became the first among major Japanese banking organizations to adopt the American-style system.

B. *New Guideline*

1. Program for Financial Revival

It is still unclear how the FSA intends to deal with the amended Commercial Code in connection with the bank regulation. It seems, however, that the FSA is now thinking seriously about improving corporate governance of unsound banks and that such movement is influenced by the codification of the new corporate governance law.

Mr. Heizo Takenaka, the current Minister for Financial Services, identified corporate governance reform as one of the three prerequisites[157] for the banking sector's recovery.[158] Following Mr. Takenaka's instruction,

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[154]Kenkyu-kai, *supra* note 145, at 161.

[155]Kabushiki Kaisha Mizuho Holdings, *Mizuho Change & Speed-up Program* (Nov. 25, 2002) *at* http://www.mizuho-fg.co.jp/pdf/release/2002/20021125.pdf.

[156]Eiji Hosoya, *Path to Revitalization of Risona (Risona Holding, Inc.)* (Oct. 9, 2003), *at* http://www.resona-hd.co/jp/e-ir/pdf/i_02a/ir_031009.pdf. For the Japanese text and the English translation of Deposit Insurance Law, see *supra* note 96.

[157]The other two pre-requisites are scrutinizing evaluation of the assets and making equity capital satisfactory. *See Kinyu-Cho PT Furyo Saiken Chukan Torimatome [FSA Project Team's Interim Report on Nonperforming Loans]*, YOMIURI SHINBUN (Oct. 22, 2002), *at* http://www.yomiuri.co.jp/atmoney/mnews/20021022mh01.htm.

[158]Yamaoka, *supra* note 77.

the FSA issued the "Program for Financial Revival," which described the framework of the new financial administration on October 30, 2002.[159]

This program incurred fierce opposition from major banks and from Japan's ruling political party, the Liberal Democratic Party (LDP).[160] The LDP is concerned about the survival of small and medium-sized enterprises whose finances depend on banks.[161] Major banks are hesitant of being placed under the government's administration.[162] "However, by promoting hard policy debate, [Mr. Takenaka] has succeeded in opening the eyes of large numbers of [Japanese] people to the country's financial problems."[163]

The Program for Financial Revival states that the following measures should be taken to strengthen the governance of financial institutions: functional enhancement of external auditors; establishment of guidelines for converting preferred stocks held by the government into common stocks; implementation of business improvement administrative orders to banks that did not accomplish their goals for sound management; evaluation of framework for prompt corrective action; and utilization of an early warning system.[164]

2. Strengthening the Corporate Governance of Banks that were Recapitalized by Public Money

The FSA issued a guideline entitled "Strengthening the Corporate Governance of Banks (Major Banks) that were Recapitalized by Public Money" on April 4, 2003 on the basis of the Program for Financial Revival.[165]

Responsibility will be assigned to management when the business condition of a bank, which was issued a business improvement

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[159]Fin. Servs. Agency, *Program for Financial Revival: Revival of the Japanese Economy through Resolving Non-Performing Loans Problems of Major Banks (Provisional Translation)* (Fin. Servs. Agency, Tokyo, Japan), Oct. 30, 2002, *at* http://www.fsa.go.jp/news/newse/e20021030.pdf; (Japanese original), Fin. Servs. Agency, *Kinyu Saisei Program [Program for Financial Revival]* (Oct. 30, 2002), *at* http://www.kantei.go.jp/jp/singi/keizai/tousin/021030program.pdf.

[160]Tani Sadafumi, *Banks Revolt Against Takenaka's Financial Policies*, J. OF JAPANESE TRADE & INDUSTRY (Jan./Feb. 2003), *available at* http://www.jef.or.jp/en/jti/200301_009.html.

[161]*Id.*

[162]*Id.*

[163]*Id.*

[164]Fin. Servs. Agency, *supra* note 159, at 11-12.

[165]Fin. Servs. Agency, *Kôteki Shikin ni Yoru Shihon Zôkyô-kô (shuyô-kô) ni Taisuru Governance no Kyoka ni Tsuite [Strengthening the Corporate Governance of Banks (Major Banks) that were Recapitalized by Public Money]*, Aug. 7, 2003, *at* http://www.fsa.go.jp/news/newsj/15/ginkou/f-20030807-3.pdf.

administrative order, does not improve because its current income or net business profit return on asset (ROA) of the fiscal year following the year when the order was given dipped from the target of the plan for sound management by over thirty percent. In this event, the FSA will take necessary supervisory measures such as giving another business improvement administrative order that requires submission and implementation of the plan that includes: replacing the representative director CEO or the person having equivalent managerial responsibility; clarifying the scope of each officer's responsibility; and significantly cutting the costs by reviewing the compensation system, restraining bonuses and terminating officers and employees.[166]

The government will exercise their conversion right if the bank passes dividend or pays virtually no dividend to its preferred stockholders for two fiscal years in a row,[167] provided, however, that if there is no particular problem with the management structure, and there is seasonable profit, the government may not exercise its conversion right. The conversion right will also be executed if Adjusted Net Profit from Core Business ROA[168] declines by over ten percent for two fiscal years in a row and over thirty percent in cumulative total, ending up in a significantly worse earnings performance such that, for example, it becomes below national average among banks.

Even if the bank falls under either of the above categories, prior to exercising the conversion right, the FSA will request that the bank fully assign responsibility to management; change the operation fundamentally by revising the organization and the business, and establish business

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[166]Recall that FDICIA and FDIA already have had the measures such as replacement of management or prohibition of management fees. *See, e.g.*, 12 U.S.C. §§ 1818(e), 1830o(d)(2), 1831o(h)(3)(A) (2000); HELLER & FEIN, *supra* note 23, § 5.09[2][b], at 5-28-29, § 5.09[2][k], at 5-30.1, § 5.10[2][e], at 5-34-35.

[167]The two year element was added because toward the end of 2002 the stock market became instable, and the officials in FSA felt that a two year allowance would help deter a crisis in March. *See Kinyû Tôchi ha Kôtai Kinyû Chô, 2ki Renzoku De Futû Kabu ni Tenkan [Corporate Governance Sets Back: FSA will Convert to Common if Bank Passes Dividend for Two Fiscal Years]*, ASAHI SHINBUN (Mar. 27, 2003), *at* http://mfeed.asahi.com/money/kaisetsu/TKY200303270111.html.

[168]Adjusted Net Profit from Core Business = Net Profit from Core Business (= real net profit from business – profit and loss from bonds) – dividend from subsidiary. Adjusted Net Profit from Core Business ROA = Adjusted Net Profit from Core Business/average balance of total assets (excluding customer's liability for acceptance and guarantees). *See* Fin. Servs. Agency, *"Kôteki Shikin ni Yoru Shihon Zôkyô-kô (shuyô-kô) ni Taisuru Governance no Kyoka ni Tsuite" no Ichibu Kaisei Ni Tsuite [Partial Revision of "Strengthening the Corporate Governance of Banks (Major Banks) that were Recapitalized by Public Money"]*, Aug. 7, 2003, *at* http://www.fsa.go.jp/news/newsj/15/ginkou/f-20030807-3.html#2.

structure that is conducive for growth in revenue; and suspend or restrain payment of dividend.

If the bank takes the above measures before the conversion right is exercised, and the FSA recognizes the appropriate measures were taken to improve the management, then the government has to wait another fiscal year to determine whether it is necessary to exercise the conversion right.

If, after considering all the various factors together, the FSA determines that the operating crisis cannot be avoided even if the FSA takes supervisory measures such as a business improvement administrative order, the government shall progress forward exercising their conversion right.[169]

3. Application of Guideline

The new guideline covers some of the sound corporate governance principles stated in "Enhancing Corporate Governance for Banking Organisations," such as setting clear lines of responsibility, ensuring that the important board members are qualified for their positions, and effectively utilizing the work conducted by external auditors.

With the application by the FSA of the above guideline to unsound banks, some of the deficiencies in corporate governance of Japanese banking organizations that have been criticized, may be rectified. Such deficiencies include a government unfocused on increasing shareholder value, and less concerned with management and shareholder responsibility.

Based on the figures of March 2003, if the government exercises the conversion right, the government's ratio of shareholding will be over fifty percent in Mitsui Trust Holdings, approximately thirty-nine percent in Risona Holdings, twenty-four percent in UFG Group, and twenty-one

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[169]Fin. Serv. Agency, *supra* note 165. *See* Naho Tokitô, *Kôteki Shikin ni Yoru Shihon Zôkyô-kô (shuyô-kô) ni Taisuru Governance no Kyoka ni Tsuite [Strengthening the Corporate Governance of Banks (Major Banks) that were Recapitalized by Public Money]*, Chuo Aoyama Audit Corp. (Apr. 23, 2003), *at* http://www.chuoaoyama.or.jp/financial/topics/banking/030423-_0101.html. As for regional banks, FSA stress the importance of relationship banking, i.e., banks maintaining close, good, and long time relationship with their customers. FSA states that Strengthening the Corporate Governance of Banks (Major Banks) that were Recapitalized by Public Money should be applied *mutatis mutandis* to regional banks; however, FSA says that the following should be considered additionally when deciding whether to exercise the conversion rights: the relationship between the bank and its customers; in case the bank is planning business restructuring such as merger with other financial institutions within one year, such business restructuring plan; support from local municipal entity and/or local industries. *See* Fin. Servs. Agency, *Kôteki Shikin ni Yoru Shihon Zôkyô-kô (chiiki ginkô-tô) ni Taisuru Governance no Kyoka ni Tsuite [Strengthening the Corporate Governance of Banks (Regional Banks, Etc.) that were Recapitalized by Public Money]*, June 30, 2003, *at* http://www.fsa.go.jp/news/newsj/14/ginkou/f-20030630-6.html.

percent in Mitsui Sumitomo Group.[170] The government should use the potential for *de facto* nationalization as leverage to entice banks to clear up the non performing loans and replace the representative director CEO if the bank does not meet the target.

Critics say that by granting banks a two fiscal year reprieve, the purpose of strengthening the corporate governance of banks is weakened.[171] That is why it is important to strictly apply the guideline so as not to take the teeth out of Program for Financial Revival.

VII. NATIONALIZATION OF BANK UNDER DEPOSIT INSURANCE LAW: THE METHOD OF LAST RESORT UNDER THE JAPANESE LAW

A. *Article 102.1 Item (3) of the Deposit Insurance Law*

Article 102.1 Item (3), which was added to the Deposit Insurance Law in March 2000, gives the Prime Minister the option to nationalize a bank, when she finds through the discussion at Counsel for Financial Crisis that the assets of a certain bank are insufficient to honor their financial obligations, and nationalization is necessary to avoid extremely serious impediment which could effect the maintenance of an orderly financial system in Japan or in a certain region in Japan where the bank is conducting business.[172]

Corporate governance under the Deposit Insurance Law's Article 102.1 is distinct from other corporate governance systems for banking organizations such as those under Program for Financial Revival in that it is mandatory from the beginning. The measures allowed to be taken under the Article 102.1 can improve the corporate governance of banks, but they are stringent, and the application of them is considered "heirloom sword" (i.e., a measure of last resort). Prime Minister Junichiro Koizumi, however, decided on November 29, 2003 to nationalize Ashikaga Bank, a major regional bank that was declared insolvent by the auditing firm, by applying Article 102.1 Item (3) of the Deposit Insurance Law and making the DICJ inject more than 1 trillion Yen from its reserve.[173] This was the first time Article 102.1 Item (3) has been applied.

On the other hand, the FSA intends to take the following measures allowed under Article 102.1 Item (3). A decision to apply such measures

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[170] *Kinyû Tôchi*, *supra* note 167.

[171] *Id.*

[172] *Supra* note 96.

[173] *Government Intervenes to Rescue Ashikaga Bank*, JAPAN TIMES (Nov. 30, 2003), *at* http://www.japantimes.co.jp/cgi-bin/getarticle.pl5?nn20031130a1.html.

is defined as "decision to impose special crisis management" under Article 111 of the Deposit Insurance Law, which shall drastically reform the corporate governance of Ashikaga Bank.[174]

B. *Methods Under Article 102.1 Item (3) of the Deposit Insurance Law*

1. Management and Shareholder Responsibility

Under Article 112, the shares of the bank under special crisis management may be acquired by the DICJ. The share certificates in the hands of the previous shareholders corresponding to the shares so obtained by the DICJ become invalid, and the pledges and collaterals on the shares are forfeited at the time of acquisition of the shares by the DICJ.

The government has decided that th DICJ will acquire all the shares in Ashikaga Bank at 0 Yen.[175] Under Article 114.2, the DICJ may dismiss directors, officers or auditors of the bank under special crisis management, subject to the approval of Prime Minister (delegated to Commissioner of th FSA under Article 139), without shareholders' consent (or board's approval in case of officers). Also, under Article 115, the bank under special crisis management is expected to initiate civil litigation against present or former directors, officers, and auditors to pursue their civil liabilities based on violations of their professional obligations (such as damages due to their breach of fiduciary duties). Further, when the directors, officers, and auditors are performing their duties and become suspicious that a criminal act (such as breach of trust or illegal distribution of dividend) may have been committed, they are required to take steps to initiate accusations.

Mr. Takenaka, Minister for Financial Services, stated that the FSA intends to pursue the civil and criminal liabilities of the present management of Ashikaga Bank under the new management.[176]

2. Board Structure

Under Article 114.1, the DICJ may appoint directors and auditors to a bank under special crisis management based on nominations by the Prime

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[174] *Id.*

[175] *Id.*

[176] *Ashikaga Gin no Ichiji Kokuyu-ka Kettei [The Temporary Nationalization of Ashikaga Bank has been Decided]*, NIHON KEIZAI SHINBUN (Nov. 30, 2003).

Minister (also delegated to Commissioner of the FSA under Article 139), without shareholders' consent (or board's approval in case of officers).

Mr. Takenaka has stated that the FSA intends to appoint the new management team of Ashikaga Bank in approximately two weeks. He further stated that a business audit committee will be newly established within Ashikaga bank and led by an outside director.[177]

3. Government Motivation

Article 102.1 requires that DICJ transfer the shares of bank under special crisis management it holds at the earliest opportunity.

DICJ plans to sell the shares in Ashikaga Bank to a third party once the disposal of non-performing loans in Ashikaga Bank is completed.[178]

C. Application of Article 102.1 Item (3)

We can see that the application of Article 102.1 Item (3) of Deposit Insurance Law shall rectify most of the deficiencies in corporate governance of Japanese banking organizations that have been criticized. In the Ashikaga Bank's case, DICJ will be required to sell the shares in Ashikaga Bank at the earliest convenience after disposing the non-performing loans, which may increase shareholder value; FSA will make the new management pursue the criminal and civil liabilities of the present management; the share certificates held by present shareholders will be worthless; and FSA will make sure that the new business audit committee will be led by an outside director.

Although the Japanese government may now have smaller hang-ups about the application of Article 102.1 Item (3), its application is still "heirloom sword." The drastic reformation of bank's corporate governance by the application of the Article will continue to be an exceptional event. Article 102.3 expressly states that measures under Item (3) shall be taken only when the Prime Minister (delegated to Commissioner of FSA under Article 139) recognizes that measures under Item (2) cannot avoid such impediment as described in the provisions of Paragraph 1. Item (2), another means of injecting public money into failing banks that may be applied when the assets of certain banks are insufficient to honor their financial obligations, merely places the bank under the administration of the financial administrator under Article 74 of Deposit Insurance Law and does not allow taking stringent measures taken under Item (3).

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[177] *Id.*

[178] *Id.*

By the application of Article 102.1 Item (3), of the Deposit Insurance Law, some of the corporate governance practices highlighted in "Enhancing Corporate Governance for Banking Organisations" such as "[e]nsuring that board members are qualified for their positions, have a clear understanding of their role in corporate governance and are not subject to undue influence from management to outside concerns"[179] and "[c]onducting corporate governance in a transparent manner"[180] can be accomplished. It can be said, however, that the mandatory nature of corporate governance under Article 102.1 Item (3) is of a different nature from the corporate governance contemplated under "Enhancing Corporate Governance for Banking Organisations," which emphasizes the importance of promoting spontaneous efforts on the side of the banking organizations themselves.

VIII. CONCLUSION

Both American and Japanese bank regulators have had the authority to supervise and inspect banking organizations to assure their safety and soundness as well as their compliance with laws and regulations.

"Enhancing Corporate Governance for Banking Organisations," Sarbanes-Oxley, and new provisions in Japanese Commercial Code have a common trend in that they all consider the oversight of the board of directors and senior management as the key to the improvement of corporate governance. Both Sarbanes-Oxley and the new provisions in the Japanese Commercial Code were enacted with the purpose of protecting investors and are applicable not only to banking organizations but to all businesses. They can be extremely helpful for the bank regulators in urging banking organizations to enhance sound corporate governance, and in improving their bank supervision function.

In addition to the enactment of the corporate governance laws, American and Japanese bank regulators are continuing to create new regulations and guidelines on banking organizations' corporate governance. In doing so, bank regulators of both countries should make sure that the practices listed in "Enhancing Corporate Governance for Banking Organisations" are reflected in express terms. These new regulations and guidelines will become clear standards for their bank supervision and inspection, and can give visibility to the sound corporate governance practice the banking organization should have.

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[179]Basel Comm. on Banking Supervision, *Enhancing Corporate Governance for Banking Organisations* 3 (Sept. 1999), *at* http//www.bis.org/publ/bcbsc138.pdf.

[180]*Id.*

The fact that both Japan and the U.S. have enacted the American-type corporate governance system can be expected to induce bank regulators of both countries to harmonize their sound corporate governance standards, which will be increasingly important in the era of international convergence of banking regulation.