A Historiographical Study of the Cross-Shareholding Structure in Japan and our Six Suggestions to the Management (August 2023)

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1. Introduction

It has been several decades since we entered the era of a highly information-oriented life, where people are rushing to cope with the multiplier increase in the quantity of information and the widening volatility of its quality, and it seems that recently, there has been a marked decrease in thinking about things in the big picture of historical trends of ourselves. Most recently, Glass Lewis, a voting advisory firm, and Institutional Shareholder Services (ISS) announced in 2020 and 2022, respectively, their unequivocal opposition to **"Cross-held shares,"** which still exist in many Japanese companies and are a relic of the cross-shareholding structure that was a symbol of the ownership structure during the Showa Period (1926 – 1989). The impact from this recommendation by global advisors on the future of Japan's capital markets will be significant.

Here, we pause to re-evaluate the merits and demerits of the cross-shareholding structure in the context of modern business history and the changes in the shape of Japanese capitalism and listed companies as "corporations" in the spirit of constructive self-criticism, and to introduce various evidence of how its role has ended with the change of the times. With a sense of urgency that there will be no future in the rapidly changing capital markets if we continue to refuse to change, I have added a discussion of my view on how things will change. I then summarize suggestions to the management of listed companies, especially to those we invest in but not exclusively to them. <u>This is not a narrowly defined paper that should be read and digested only by companies with large cross-held shares, but rather a broad overview of how to design the shareholder base in the future for all Japanese companies.</u>

I live in the business field as an investment professional, not as a scholar. Therefore, the basis of my argumentation is built on many past and present academics' papers, and I hope you will forgive me if some of my own viewpoints are included when piecing them together. I will try to be as accurate as possible in my citations so that the difference between "facts," "academics' views," and "my own view" will be clear. Of course, if you are interested, I would be happy if you would refer to the original papers. We hope this paper will provide hints to perceive future changes in the capital market positively.

2. Problem Statement – Globalization of Investment and Japan's Changing Market Structure

The fact that the reappointment rate of top management of large companies has dropped significantly from last year during the 2023 AGM season has been greeted with shock among corporate executives and fresh surprise among investors. Since January of this year, the Tokyo Stock Exchange ("TSE") has been making suggestions to listed companies to seriously consider the cost of capital and to improve ROE, which has been discussed as the "1x P/B ratio problem," but the decline in the reappointment rate has been more significantly impacted by the new addition of the "policy shareholding criteria" by ISS, in addition to the ratio of outside directors (at least 1/3 or 2 person) and ROE criteria (5-year average of at least 5%) following Glass Lewis's judgment in 2020.

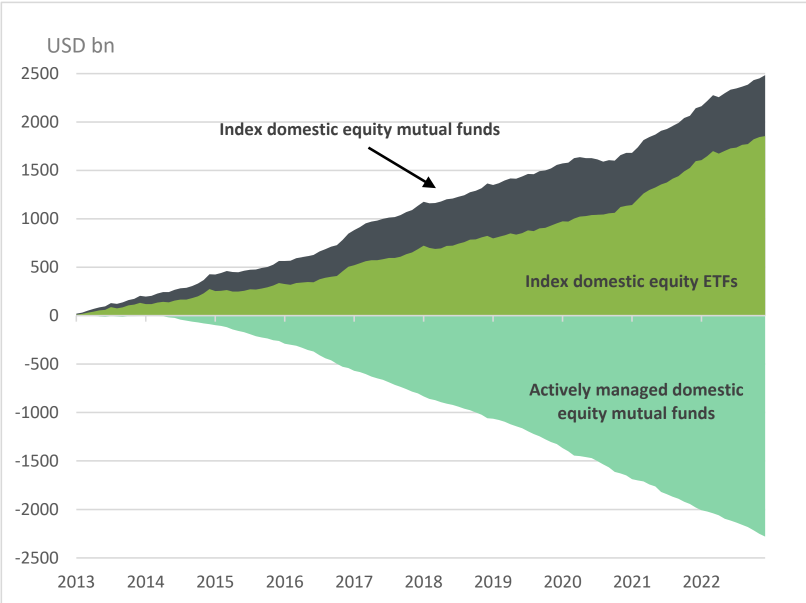
Specifically, ISS introduced a new standard on February 2022 that: "ISS will recommend against the top management of companies with excessive cross-shareholdings (policy shareholdings) of 20% or more of net assets". Glass Lewis, the world's second-largest voting advisory firm, has already decided to recommend against the top management of companies with policy shareholdings of 10% or more of net assets from the 2020 general shareholders' meeting, thus closing the moat.

In 2022, many institutional investors, especially domestic ones, seemed to follow the previous year's voting behavior, perhaps because of the short period between ISS's announcement and the general shareholders' meeting in March/June. Still, in 2023, after due consideration, many domestic and foreign institutional investors recognized the difficulty of explaining their decision "not" to follow the advice of the two major advisory firms when they set such standards. In 2023, after due consideration, it can be seen that domestic and foreign institutional investors in many companies turned against the reappointment of the company's top management. The mega banks, which had been at the center of cross-shareholding relationships during Showa era, have announced reductions in their policy shareholdings in rapid succession, possibly trying to respond to the direction (in Chapter 9).

Perhaps the most symbolic event of 2023 was the sharp drop in the percentage of votes in favor of two representative directors to 57-58% from the 70% level of the previous year for Fuji Media Holdings, a TV company whose foreigner votes are limited to 20% of total by the Broadcasting Act. Fuji Media Holdings, whose top shareholders include major corporations such as Toho, Bunka Hoso, and NTT DoCoMo, symbolizes a company still firmly protected by Japan's old-style cross-shareholding structure. Still, this result has already left many executives with the impression that the market structure has changed dramatically.

It is said that about 60%[1] of Japan's daily stock market trading is already conducted by foreign investors, and a large portion of it is said to involve passive investments (ETFs and index-approximating transactions). This shift to passive investing is, first and foremost, a global trend (Figure 1), but it is also said to be more advanced in the Japanese market. The low ROE and Corporate Governance quality of the overall Japan market as well as the large number count, nearly 4,000 of listed companies made it less cost-effective to monitor fundamentals closely as active fund manager. GPIF, the largest public pension plan in the country, has also raised the passive portion of Japanese equities from an average of the low 70% range between 2005 and 2010 to nearly 94% in 2021[2].

Figure 1: US mutual Funds and ETF flow



Source: Investment Company Institute, "2023 Investment Company Fact Book.

[1] https://www.jpx.co.jp/markets/statistics-equities/investor-type/index.html

[2] https://www.fsa.go.jp/en/news/2023/20230620/20230620.pdf (page 12)

Passive investments are mostly conducted mechanically by purchasing listed ETFs or by selecting several hundred companies to invest in according to a target index and rarely exercise voting rights based on a particular understanding of the circumstances of individual companies or the future direction of their management stances by nature. In many cases, they mechanically follow the policies of advisory firms such as ISS. To include constructive self-criticism, because the corporate governance improvement of Japanese companies has been slow, foreign funds have generally reduced their investment in Japan, which has prevented active fund manager from growing and spiral, in which most investors became of the "tick-the-box" type in exercising their voting rights, a result from the cause-and-effect relationship between Japanese firms and market participants.

Against this backdrop, the Japanese stock market reached a turning point in 2023 when the world's two largest voting advisory firms said "no" to Japanese cross-shareholdings. Will companies stand on a more evolved board management and governance mindset and face the increasingly globalized capital markets head-on, or will they go private or accept M&A from other companies to distance themselves from the increasingly ESG-oriented governance demands and various shareholder actions in the future? Many companies will have to decide whether to go private or to accept M&A from other companies to distance themselves from the increasingly ESG-oriented governance demands and various shareholder actions.

The big question from the author, as an investor, is "Why did this cross-shareholding structure emerge in Japan, and why has it continued to this day?”. As a Japanese citizen, I do understand that there is a certain amount of emotional nostalgia behind the continuation of this structure beyond necessity. However, I believe that this form of capitalism, which is unique to Japan, has been "airbrushed" into society for so long that it has delayed the deepening of a sense of corporate governance, amplified the shock from the fostering of the bubble economy to its collapse, and contributed to the lack of proactive approach towards digital revolution in the 21st century (in Chapter 8).

In this highly information-driven world, rapid changes in the business environment are devastating. Today's corporate managers, in general, are being pressed to respond daily to such noise and not being able to digest and understand the essential meaning of the cross-shareholding structure, the background of its significant contribution to Japan's rapid economic growth in the past, and the fact that it has had a significant negative impact on the subsequent evolution of corporate governance. Here, I have taken an in-depth look at a series of questions such as "What were the origins of cross-shareholdings?" "How it has evolved in the first place?" "Why should it be dissolved now?" and "What is the ideal shareholder structure companies should aim for?". Then I will make sincere suggestions based on such comprehensive base discussion. Although I am aware that the definitions of "cross-shareholdings," "policy-shareholding" and "stable shareholding" are different, I proceed as if they were almost identical, since, in terms of the depth of their impact on corporate governance, they are essentially the same.

To dissolve cross-shareholding is to "change the common practice," and one might hesitate to do so considering the thoughts of our predecessors; this is precisely the area where the power of governance must be effective, not at an individual level, but as the board of directors as a whole. It is common in long historical cycles that something that appeared and was highly effective in one era becomes meaningless or even damaging in the next era and ceases to serve its purpose. From the perspective of dispassionate business history study, rather than vague nostalgia, this paper recognizes that cross-shareholding structure had an extremely positive effect on Japan's growth and served its intended purpose at one time so that it enables you "dispassionately" to move on from there.

3. Vertically Integrated Capitalism – Ownership and Management before World War II

Eiichi Shibusawa(1840 – 1931), a legendary figure with setting the course for the dawn of capitalism in Japan, is credited with founding more than 500 companies, and there has been much research on the dynamic corporate creation that took shape during the early to mid Meiji period, shaped by him and other entrepreneurs (Meiji Period 1868 – 1912). While the dynamism and stories of this period is too abundant to discuss here, it definitely symbolizes a time when Japan was "breaking away from its shackles" and people competing vibrantly to create something new.

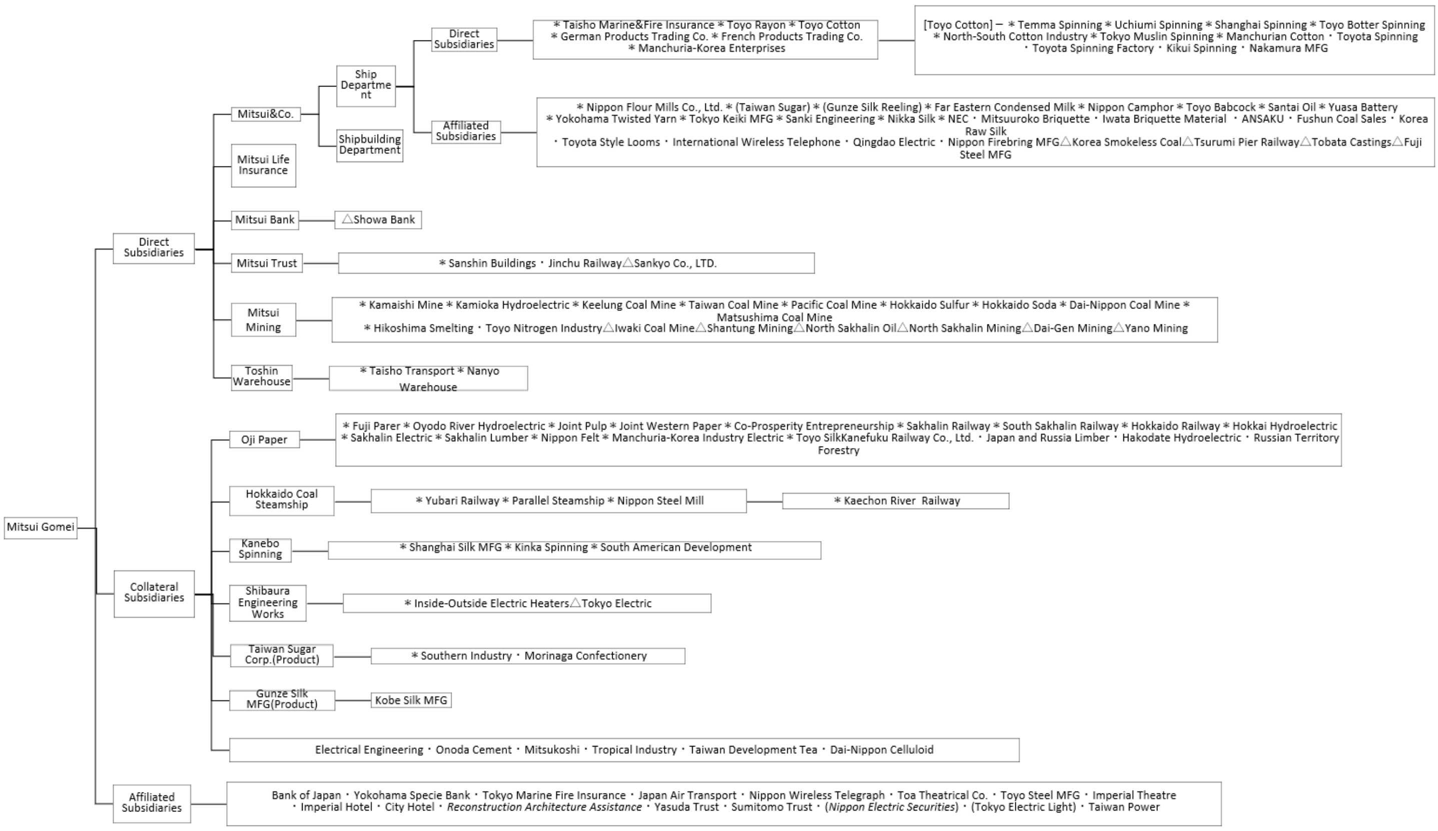
It is also true that all businesses were promoted under the leadership of a very few influential individuals, as this was a time when the accumulation and advancement of industries were necessary in the face of scarce capital availability. Along with the up-and-coming new groups led by Shibusawa and Okura, it was also the Zaibatsu groups such as Mitsui and Sumitomo, which can be said to still dominate Japanese society even today, that evolved and deepened their groups during the Meiji era through their continued influence and financial power since the Edo period[3].

Under the slogans of "wealthy nation, strong military, 富国強兵" and "industrialization and promotion of industry, 殖産興業" Japan responded desperately to import technology and strengthen its national power, but it also made good use of the company system imported from the West, especially the "joint-stock company 株式会社" system. By using this system, many Shibusawa-affiliated companies quickly expanded their businesses. The joint-stock company is an excellent system that allows both concentration of capital and limitation of risk, and from the outset, (1) limited liability for all investors, (2) corporate bodies (general shareholders' meeting, board of directors, auditors, etc.), (3) transferability of shares, and (4) fixed capitalization system were put in place, which would significantly contribute to the development of capitalism in the following years.

In the early days, there were a few different types of “Corporation/Company”, such as Gomei Kaisha（合名会社）and Goshi Kaisha（合資会社）– which both actually a non-limited liability forms in Partnerships. For example, the Mitsui Zaibatsu, originating in Mitsui family, a merchant that had been in existence since the Edo period, established a corporation called Mitsui Gomei Kaisha in November 1909, and over the next several decades, further expanded its business greatly. The great power of Mitsui Zaibatsu can be seen in Figure 2, as of 1937, in the book by economist and business economist Professor Katsuhito Iwai.

[3] Mitsubishi was formed as new Zaibatsu group in Meiji period

Figure 2: Ownership pyramid of Mitsui Zaibatsu (1937)



(Note: * indicates decisive Mitsui control, △ indicates semi-controlling, unmarked indicates weak control

Source: Prepared by Hibiki based on "What Will Happen to the Company?" by Katsuhito Iwai

Aside from the difference in the corporate form, the important fact is that ownership and management were unseparated in Japan during the Meiji Period and before World War II.

Figure 3: Corporate managers by their origin

	1900	1928	1962
Owner Manager	62.5%	22.1%	11.8%
Employee type Manager (Lifetime Employment)	5.5%	22.9%	47.8%
Employee type Manager (Lateral Hire)	31.8%	55.0%	40.4%

Source: Tetsuji Okazaki and Masahiro Okuno, "The Origins of the Modern Japanese Economic System

As shown in Figure 3 above, in the mid-Meiji period (1900), owner-operator-type managers (managers who are significant shareholders of their business) accounted for 62.5% of the total, and this was actually mainly due to the old Commercial Code (revised in 1893) which required that one must be a shareholder to become a director. When the Commercial Code was changed, and the scale of the economy and the number of companies expanded rapidly, there was a rapid increase in the number of so-called "professional managers" who were headhunted by other companies. As a matter of fact, in the case of Mitsui zaibatsu, Hikojiro Nakamigawa, a nephew of the famous Yukichi Fukuzawa, who originally served Mitsubishi Zaibatsu as one of the executives, was scouted by Mitsui to run the business as "professional manager". A person such as Hikojiro falls under "Laterally hired employed manager," in the table and it was customary for such an employed professional manager to borrow large sums of money to buy into the company shares after assuming office. With such common practice in place, unseparated ownership and management style was maintained.

This pyramidal, top-down and skin-in-the-game type ownership structure that developed throughout the Meiji period to early Showa period was wiped out with general D. MacArthur established General Headquarters' (GHQ) post WWII dismantling of zaibatsu. In Mitsui's case, for example, by creating a hierarchy of 50% or more ownership in subsidiaries, sub-subsidiaries, and great subsidiaries (with the remainder coming from the pocket of professional managers), the Zaibatsu group was able to control businesses many times larger than its actual capital holdings while maintaining control which multiplied the power of those Zaibatsu empires. Such a framework was accused and crushed by the order of GHQ. Interestingly, in countries such as Italy, or Korea such pyramidal corporate structures still remains with strong power.

Furthermore, the period from the late Meiji period to the early Showa period was a time of extremely high corporate M&A activity due to the dawn of capitalism, an intense thirst for growth, and with many owner-operator type managers. For example, Keita Goto, the founder of the Tokyu Group and sometimes derided as a "robber Keita," used aggressive take-over techniques to rapidly expand the group, particularly in the railroad business.

Something which will be one of the key issues in our paper is the debate of "Corporate personhood" or "Juridical personality". The debate over whether a corporation (company) is a thing or a person[4].

From the viewpoint of Keita Goto, who regarded a corporation simply as means to buy or sell businesses, a corporation is considered a “thing”. In actuality, a corporation IS a "thing" in the sense that it has no personality and has to have a representative (representative director) living person who signs or seals various contracts (services, labor, procurement, asset purchase etc.) because it has no “thoughts or hands” to do so. At the same time, however, a company is “a person” in the sense that it can actually become the legal owner of the assets of its factories or facilities but most prominently can become shareholders of other corporations. Such a relationship can be referred to as a human being versus its organs or clothes. This odd feature of the joint stock company system, which can be seen both as a thing and also as a person, is the foundation of the great development of capitalism and also the starting point for the never-ending **“principal-agent problem”** between shareholders and managers.

Even if a company builds a pyramidal structure in which it owns other companies as a person, such as in the case of conglomerates of the Meiji period, the ultimate top layer was just a handful of human being sitting there as interested shareholders as well as being directors of their own company. In this top layer, as you can see, the corporation becomes a “thing”. This is just identical to small privately held family businesses.

With such a structure in place, corporate management will be destined by the moral sentiments of such owner(s), and corporate governance becomes subordinated to it. Many such top managers in the Meiji or Taisho period used this system to line their pockets by paying out huge dividends to themselves regardless of the state of the business itself. The reality of such a situation around 1916 (Taisho 5th year) is described in a book titled "Managers of the Past and Present," written by Tatsunosuke Takasaki, who founded Toyo Seikan, still the largest can and packing company in Japan (Ticker 5901), and was the first president of the Electric Power Development Company (Currently called J Power, ticker 9513) (Figure 4). The reason why Mr. Eiichi Shibusawa is a legend even well respected by P. Drucker[5] and also why Eiichi’s famous book "論語と算盤 - Rongo (Analects of Confucius) and Abacus" is still read by CEOs now in Japan is

4 Katsuhito Iwai “What will happen to a Company” (only in Japanese)
5 Drucker praised Eiichi Shubusawa in the preface of Japanese version of “Management for Results”

because of his high ethical standards, based on a spirit of "士魂商才 - Samurai spirit with business mindset," in which he pursued both public and economic interests in a balanced manner even during such time many people were driven by greed.

Figure 4: Takasaki, "Managers of the Past and Present" - About year 1916

> "The first thing I didn't like was that, unbeknownst to the company's employees, a large number of the company's shares were often transferred from A to B, and with each transfer, the management changed, and the corporate policy was never set." "Second, the management leaders are paying high dividends to please the shareholders rather than to improve the company's fundamentals. Such selfish managers were more concerned with the rise and fall of the stock price than with the company's business performance. In other words, the power of the shareholders was so great that voices of those employees were simply ignored."

Source: Tatsunosuke Takasaki, in "Managers of the Past and Today"

The end of the Edo period to the Meiji Period was like the Wild-Wild-West in America. Many of the wealthiest families in the Edo period continued to manage their businesses in the old-fashioned way which family members drove strategic matters and butler type management (called Banto, 番頭) running day-to-day work. As a result, most of these prominent families could not adapt to the fast changing social and economic environment and declined. This division between "strategy and tactics" proved fatal during turbulent times.

In 1710 (in the middle of Edo Period), Mitsui family introduced a holding company-partnership-like structure called "Omoto-gata, 大元方" to collectively manage the wealth of the nine (later eleven) Mitsui families. This idea of collective family management was the foundation of the later established Mitsui Gomei Kaisha in Figure 2. Here, the distribution of profits among the families was done through discussions, and each family was not allowed to dispose of its assets without permission from the whole group. The family constitution stipulated that the entire family's assets should be "shared and owned in whole, 総有" by the family and that the family should cooperate with each other to develop the business. In other words, the concept of "ownership," which legally refers to freedom of use, profit, and disposal, was restricted. Based on the viewpoint of ensuring the family's survival over the very long term, the self-righteous temptation to dispose of assets due to ups and downs was eliminated. With such restriction in place, an excellent professional management Rizaemon Minomura was hired to oversee the whole business (CEO in current form). Herein lies one valuable hint of the idea of cross-shareholding structure that made corporations become "persons" which evolved after World War II to protect the long-term perspective of business management. It is extremely interesting to note that at the top end of the pyramid at Mitsui Zaibatsu, there was a "harmonized" setting that resembled a cross-holding structure, in which a small group of interested parties loosely cooperated and checked on each other.

4. The Eve of Cross-Shareholding – Chaotic Post-war Period during 1945~1960

Returning to Japan from Manchuria after World War II, Takasaki, mentioned earlier, saw that the Japanese capitalism state had completely transformed from what it had been before the war. Here is an excerpt from his book again.

Figure 5: Takasaki, "Managers of the Past and Present" - About 1947

> "The shareholders' interests were totally disregarded and the management of the business was controlled by the employees, exactly the opposite of the situation when I first returned to Japan in 1916." "In other words, stock dividends were a secondary concern, and the treatment of employees was the first priority, with no one thinking about strengthening the company's foundation or accumulating capital. This trend has gradually improved in response to capital needs, but there has been no fundamental change."

Source: Tatsunosuke Takasaki, in "Managers of the Past and Today"

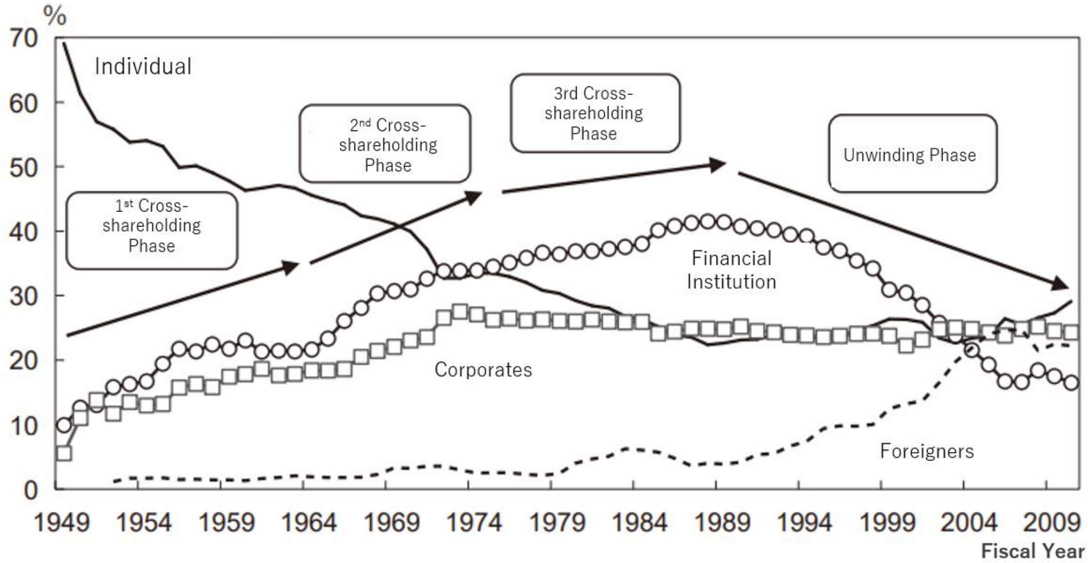
In November 1945, immediately after the war ended, GHQ initiated the dissolution of Zaibatsu through the "Memorandum on the Dissolution of Holding Companies.". Also, in December 1945, the Labor Union Law was enacted, which completely transferred the sovereignty of joint-stock companies to workers. First, the shares owned by Zaibatsu families or their holding companies were forcibly transferred to the Holding Company Liquidation Committee, and then a heavy property/wealth tax was imposed on the riches which amounted to about 10% of GNP at the time. It is said that approximately 30% of this property tax was paid "in-kind" in the form of stock certificate, which meant the Zaibatsu and related families that had dominated the society until then wholly lost their power, and so the shareholding structure was forced to change all at once.

Turning onto the management side, many of the leading corporate managers of the time were ousted due to being supportive of war activities under the 1947 Public Office Ouster Order（公職追放令）and the 1948 Zaibatsu Family Controlling Power Elimination Act (財閥同族支配力排除法). In order to avoid these companies becoming headless, internal promoters succeeded in the top managerial positions in most companies, and in many cases, these successors had no previous management experience at all. They were working-class personnel who had been at the mercy of the savage logic of aggressive pre-war capitalism. This is why the pendulum swung so quickly to emphasize workers, leading to the comments by Takasaki in Figure 5. In a novel titled "Third Class Executive (三等重役, 1952)" written by Keita Genji, the main character has suddenly become the president of a company from the position of general administrative manager, regardless of his intentions as the former president had been expelled. It is an interesting comically depicted fiction in a mixture of tragedy and joy and became a big hit at the time.

As we can see from above, the post-war social and economic revival began by altogether denying the common sense of pre-war corporate behavior, both from the perspective of ownership structure as well as the management style. Banjo Otsuka, the committee chairman of Economic Club Economic Democratization Committee (経済同好会経済民主化委員会), stated, "The private interests of the capitalists should be abandoned, and the public interest should be substituted for the voice of society". From here the big issue of (1) ownership structure problem and (2) company management problem simultaneously arose, and <u>as a prescription for this complicated problem, the cross-shareholding structure, which continued to expand until the 1980s and is still considered a problematic issue in Japan today, began.</u> Of the two issues, I would like to touch on the ownership structure first.

To change the top-down form of capitalism that had run amok with the military expansion during the pre-war period, the GHQ and the new government redistributed the shares collected from Zaibatsu and wealthy individuals to the public, which were then purchased by employees and others, with the idea of wealth being widely dispersed among the citizens. As a result, in 1949, when the TSE was first established, the percentage of shares held by individuals was extremely high at 69% (Figure 6).

Figure 6: Shareholding Ratio by Owner Type



Source: Hibiki translation of “History of Cross-shareholding and Outlook”, 7/2011 by Daiwa Institute of Research Ltd.[7]

Initially, right after the war, 325 influential large companies were designated for dismantling by the order of GHQ, but due to the intensifying of The Cold War against communist nations, Japan suddenly became an important far-east ally of the US and so, only with a few exceptions, most of those 325 companies (luckily) continued to exist untouched in order to prevent social upheaval. More importantly, banks were excluded from those dismantling from the start for the same social stability reasons, which were also allowed to own, or newly purchase, up to 5% of any company's outstanding shares.

Amid such a situation going through forced ownership structural changes, the suspension of the Reconstruction Finance Corporation (復興金融公庫) and the impatient sale of shares then held by government agencies caused a severe recession, forcing many individual shareholders to sell their shares to make ends meet, and soon banks began to swallow such shares in large scale. At the same time, more and more of the shares accumulated by antagonistic speculative activists were gradually taken over by friendly groups giving a hand or carefully acquired by them in pre-caution to such threat. These emergency evacuation moves were the first phase of cross-shareholding formation.

5. A New Capitalism in the Showa period – Acceleration of Cross-Shareholding

As mentioned earlier, the post-war dismantling of Zaibatsu and the subsequent dispersion of shares has led to frequent cases of large share purchases by money craze hostile buyers and takeover attempts of asset-abundant former Zaibatsu-affiliated companies. It was the biggest headache for the many young inexperienced corporate managers. This is where the issue of (2) company management problem (mentioned in the previous chapter) becomes important. At the time, it was prohibited to establish a holding company, due to being seen as a symbol for the pre-war capitalist structure, and so in order to protect the long-term perspective of the management of a company, a cross-shareholding structure was established and accelerated, in which the group, including the banks, maintained horizontal relationships and mutually supported each other.

The symbol of this formation of corporate groups can be seen in the establishment of "group presidents' roundtable, 社長会" which began successively around 1950 and still exist in many groups today, mainly among former Zaibatsu and banking groups (Fig. 7).

Figure 7: Group Presidents' Roundtable of Major Corporate Groups (as of 1996)

	Mitsui	Mitsubishi	Sumitomo	Fuyo	Sanwa	Dai-ichi Kangyo
Name	Niki-kai	Kinyo-Kai	Hakusui-kai	Fuyo-kai	Sansui-kai	Sankin-kai
Companies	26	28	20	29	44	48
Established	1961	1954	1951	1966	1967	1978
Frequency	Monthly First Thursday	Monthly Second Friday	Monthly Fourth Wednesday	Monthly Fourth Monday	Monthly Third Wednesday	Every three Month Third Friday

Source: Masaru Udagawa and Jun Ikushima, "Japanese Business History Study from Managers."

The main reason for cross-shareholdings was to protect companies from short-term shareholders and to grow business and industry from a long-term perspective, which, of course, was in line with the direction of the Japanese government at the time and gained momentum. One of the "Basso Continuo" that ran through this cross-shareholding idea was the desire by corporate managers to stabilize employment (i.e., prevent workers from flip-flopping their jobs, which was common in those days). It was most important for companies back then to accumulate in-house wisdom and technology similarly as to stabilizing the capital base in order to catch up with Western countries and companies. Thus, it was essential to keep skilled-workers stay happy in the organization to brush up the "organizationally developed" know-how.

So, due to such a protective manner for labor procurement, the formation of "company-based labor unions" became mainstream which is something very unique to Japan, and ties between employees, regardless of whether them being blue-collar or white-collar collar became so strong that it created a family atmosphere within a company. This "family-unity," in which factory workers and clerical staff within a firm (as well as the management) develop a close "ally" relationship, became the driver of rapid economic growth in the 1960s and 1970s. Such a relationship between management and the workers was first analyzed objectively in J. C. Abegglen's "The Japanese Factory," published in 1958, and within this book, the concept of "lifetime employment[6]," was first introduced to the world, a practice that still persists today in Japan.

Abegglen did not only praise the characteristics of Japanese management but also criticized it constructively in his book, saying that workers were overly protected, and productivity was extremely low compared to the West. Still, there is no doubt that such a management style was the driving force of rapid growth even embracing some inefficiencies. In the 1970s, a movement emerged to deify Japan's (1) lifetime employment, (2) seniority-based wages, and (3) company-based unions, and ultimately the famous book "Japan as Number One" by E. F. Vogel was published in 1979 during the peak of Japan's economic power, which argued that the world should learn from Japanese management methods.

Based on the viewpoint of management history study, we can see that Japan's unique cross-shareholding structure was formed under extremely path-dependent conditions in its early time and fostered through the ups and downs of economic growth. It is a historical fact that Japan, supported by such ownership structure, has become an economic superpower on par with the major industrialized countries in a short time frame of 20 years. However, it is now generally recognized that, while praise of Japan was reaching its zenith, such internally supervised Japanese corporate governance structure of the time actually

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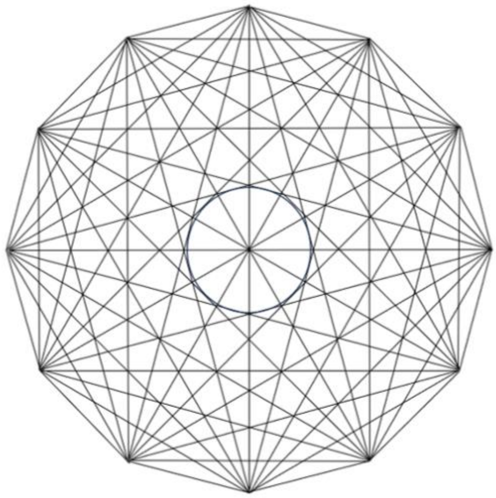
[6] It was originally referred to as lifetime commitment in the book but eventually became told as lifetime employment

unintentionally helped the paths towards bubble creation. This discussion will take place in Chapter 7.

Let us now make a quick turn to the theoretical part of the cross-shareholding structure. This is the issue of the “Juridical personality” of corporations. Let me cite here the argument by Dr. Katsuhito Iwai: The following dodecagonal diagram by Mr. Iwai poignantly expresses the problem's essence.

Figure 8: Conceptual diagram of cross-shareholding structure by 12 companies



Source: "What Will Happen to the Company?" by Katsuhito Iwai

In this hypothetical situation, 12 companies form a corporate group, and under a loose alliance of mutual support, they each acquire 5% of the shares of the other 11 companies. In this way, 55% of the company's outstanding shares would be owned by the 11 mutually supportive companies, effectively controlling decisions such as the reappointment of directors with the group ownership. With a mutually owned 5% stake within 12 companies, it would be possible to build a structure that would make the voting rights of ordinary shareholders almost powerless, and the management direction will be monitored through group governance. This is a fascinating truth that, even in a capitalism world where “competition” is the basis of its theory, the existence of a "non-contractually binding horizontal relationship" can dominate. While such a phenomenon is not common, it can actually be explained under the norms of Japanese people where virtues of “harmony” or “mutual trust” tend to be superior. It is a very interesting historical phenomenon which (due to its complexity) I would like to leave further discussion of this to other ambitious scholars.

In such a partnership structure, normally the commercial bank would act as a watchdog, monitoring the company and providing capital in the form of lending. And, there was a tacit understanding that banks would not intervene unless some crisis situations occur. The basic consensus was that management would not be at the mercy of various shareholders' short-term voices and that capital accumulation and technology enhancement would be prioritized. To put it another way, the environment was such that, although there were no specific controlling shareholders and the company not being an owner-operator, the manager who had been promoted internally to take charge of management could act as the leader of the board of directors as if they were the owner. This self-fulfilling framework actually resembles the situation in the U.S. during the 1930s and 1960s, widely known as the time for the “Managerial revolution” (discussed in Chapter 6) .

There were also regulatory frameworks that supported such an environment. In 1950, Corporate Law introduced a “board of directors” and a “representative director” system, but independent outside directors were not required back then, and in many situations, group company management members served as outside directors. Unlike the situation of the US where CEOs were constantly faced with shareholder scrutiny (except for managerial revolution period), the representative director system was introduced (from the US) merely as a formality. In Japan, the person who has won the power battle of internal promotion became the president and then naturally also assumed the role of representative director simultaneously without much considerations. In a period of relatively stable social environment with reasonable growth, such mutually fulfilling, and relationship-based management style fared well since it helped the notion of “continuous improvement” demonstrated in the “Kaizen” style of Japanese companies.

The characteristics and problems of the corporate governance system and board management at that time are briefly summarized in "The Japanese Management System as a Managerial Revolution and Japanese Corporate Governance Code as a Shareholder Counter-Revolution (2023)" by Yukinobu Ota. However, this is an area where different researchers have different views, and I generally agree with Dr. Ota's view.

- **Weak shareholder bargaining power due to cross-shareholding structure (silent shareholders)**
- **Assets being crystalized for cross-shareholdings, hollowing out of shareholders' equity, and overreliance on indirect financing.**
- **Board of directors dominated by promoted insiders, with no external checks and balances; absolute power of representative directors**
- **Homogeneous organization within a seniority-based promotion system centered on lump-sum hiring of new graduates and male employees**
- **Lack of liquidity in the management talent base and the absence of a management replacement market**
- **Company-based labor unions and coordinated approaches with the management team weakening the voice of workers**

This mutually beneficial relationship still exists today in the form of "policy shareholdings" and "stable shareholders," and I believe that it is a serious problem that weakens the essential power of corporate governance. One can only imagine what Eiichi Shibusawa and Tatsunosuke Takasaki, who embodied the highest ethical standards both as capitalists and as corporate managers, would have thought if they had witnessed such a situation in later time in Japan.

6. History of Shareholder Structure in the U.S.

While the previous chapter discussed the historical path of the "separation of ownership and control" in Japan and its potential impact on logic and governance, this chapter will briefly introduce the fact that the United States has also experienced a significant ebb and flow in capitalism's growth period. What is perceived as unique to Japan is only a superficial understanding of the phenomenon, and both Japan and the US have experienced similar situations in terms of structural development and change in tug-of-war between management and shareholders. We believe this chapter provides a hint as changing direction in the ownership structure of Japanese listed companies, which is expected to proceed rapidly.

An inescapable part of the historical study of US capitalism is the book "The Modern Corporation and Private Property" co-authored in 1932 by corporate lawyer A. Berle and economist G. Means. This paper is a grand empirical study conducted by the two, which raised the issue that the US corporations has become too large in its growth procedure and the raising large sum of capital decentralized the power of the shareholder, and it caused shareholders in general to become uninterested to the management of the company. Professional managers[7] who generally do not own shares in the company have come to control the company, creating a severe governance problem. Berle and Means, who defined "managerial control" as companies in which the major shareholders hold less than 20% of the outstanding voting rights, found that these managerial controlled companies accounted for 44% of the total in their survey of 200 large companies in 1929.

With more favorably interpreted point of view, J. Burnham proposed in his book "The Managerial Revolution" in 1941 that the coming of the era of ownership-based control to the era of non-ownership managerial control was a revolution of capitalism by managers. There were serious arguments pros and cons about this among scholars back then but democratization of the stock market and the decentralization of ownership were generally considered a good thing at the time, in contrast to the Rockefellers, Carnegies, and other major capitalists who had long maintained a structure of ownership and control. We believe such belief was behind GHQ pushing the dismantling of Zaibatsu groups in post-war era in late 1940s in Japan. Interestingly, although there was criticism towards this decentralization of ownership structure, the phase of managerial control continued to dominate until the 1960s.

US capital markets in the post WWII period became a boom and it ignited the ambitions of many professional managers to expand their companies. With that said, in the late 1960s, M&A activities expanding the business frontier became hugely popular with disregard to synergies or profitability. Many large companies became conglomerates, and the decline in profitability proceeded inevitably. This booming capital activity was supported by pension funds and mutual funds, which also began to emerge in the 1960s, and the trend of these institutional investors gradually gaining power in the market was called the "shareholder counter-revolution" as the antithesis of the "managerial revolution".

Such counter-revolution was triggered by the implementation of Employee Retirement Income Security Act of 1974 (commonly known as ERISA) and the

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[7] Mabel Newcomer's 1950 survey of 428 companies found that 50.9% of professional managers owned less than 0.1% of the stock of the companies they managed, and 32% owned between 0.1% and 1%.

Internal Revenue Code of 1978 (401K), which were enacted to protect the retirement of the generation of national heroes who served in the World War II as they were approaching the next step in life. Simply put, taxation on gains from stock investments was deferred until after retirement, increasing the incentive for many employees to invest in stocks, and companies saw this as a business opportunity to create a specialized department to manage such pensions rather than investing individually. This phenomenon has dramatically transformed the ownership structure of the market (Figure 9).

Figure 9: Changes in Share Ownership Structure in the U.S.

	1970	1980	1990	1995	2000
Individuals	68.0	58.6	50.3	49.1	42.6
Public Sector	0.0	0.0	0.1	0.3	0.7
Banks	0.0	0.0	0.1	0.1	0.1
Insurance Fund	3.3	5.3	4.6	5.3	6.5
Pension Plans	9.2	18.5	25.1	23.2	19.0
Mutual Funds	4.7	2.8	6.6	12.1	18.5
Others	11.6	9.8	6.3	3.7	2.6
Foreigners	3.2	5.0	6.9	6.2	10.0
Total	100.0	100.0	100.0	100.0	100.0

Source: "Corporate Governance of Japanese Companies, New Edition," by Y. Teramoto and T. Sakai.

Initially, institutional investors were short-term oriented shareholders, who frequently bought and sold their shares. However, as the US economy fell into a recession after the Vietnam War and restructuring and decomposing type M&A activity increased, frustrated institutional investors gradually turned into activists who use their position as major shareholders to exert pressure on companies to reform their management to raise their stock prices. CEOs who were perceived as insensitive to stock prices were frequently ousted even at major companies such as IBM, and the term "Revolt in the Boardroom " became a household word.

At the same time, large private equity funds such as KKR and Blackstone emerged, exercising new financing methods such as LBOs by issuing junk bonds, and revitalizing the corporate control (M&A) market. Naturally, due to the large number of voting rights they hold, it was mainly the institutional investors who hold the casting board for the success or failure of such M&As and so their voice and influence became even bigger. With such a landscape, in the 1990s, the era of managerial control ended completely, and a new era of strengthened shareholder rights have arrived.

As you can see, a quick look at the transition of the ownership structure in the US market reveals that even the US has undergone a significant shift in the ownership structural swing between company acting like “a person” by itself (with professional CEOs pulling the strings) to becoming “a thing”. In Japan, "managerial control" was realized as a path-depending consequence in the cross-shareholding structure that emerged as a pile-up in the chaotic post-war period. In contrast, in the US, the same "managerial control" was achieved due to the indifference and powerlessness of shareholders as the extreme democratization (decentralization) of ownership progressed. I believe this was not an accident but an inevitability like the invisible hand of God, arranged by the capitalism to speed up management decision-making during the high-growth period and enhance the accumulation of technology and competitiveness of companies.

The real problem here is clear. In the US, the emergence and rise of such institutional investors have brought a shareholder counterrevolution, and the evolution of governance monitoring functions in the capital markets and the resulting revitalization of corporate dynamism have led to an unprecedented boom in the stock markets that continues to this day. However, in Japan, this shareholder counterrevolution has yet to be fully realized due to the prolongation of cross-shareholding structures ("policy shareholdings" and "stable shareholders"). <u>The key assumption underlying this paper is that this trend of shareholder counterrevolution will finally, rapidly, and irreversibly come to fruition.</u>

7. On Fostering a Bubble Economy

The development of the post-war cross-shareholding structure and its governance problem was discussed in Chapter 4, and in this chapter I will touch on the macroeconomic impact that the cross-shareholding structure may have had during the bubble-building period in Japan.

The height of the cross-shareholding structure and its demise began during the bubble period of the 1980s. Japan’s economy faced chaotic changes throughout the 1960s and 1970s with two Kennedy shocks in the 1960s and two oil shocks in the 1970s and surely it was a difficult time for companies and the stock market. In the 1960s, the spiraling sell-off accelerated, and the government set up an emergency stock purchase program and subsequently sold the temporarily accumulated shares to group companies and banking groups after the market stabilized, and this further accelerated the cross-shareholding structure. Also, with the liberalization of Foreign direct investments, concerns about foreign investors to takeovers arose, and companies, in their precautious move, began to further build on stable (friendly) shareholders. Figure 10 below shows the top six major shareholders of major companies taken from the 1980 Company Handbook (Kaisha Shikiyo, New-year edition). Although it is not as apparent as the “5% each” example that was discussed in Chapter 5 which gives a theoretical level of total control, the structure we see here is quite close to that level with only 6 top shareholders being counted.

Figure 10: Shareholder Composition of Major Companies in 1980 (selected)

Sumitomo Bank		Mitsui&CO		Mitsubish Heavy (MHI)		Shin-Nippon Steel	
Sumitomo Life	5.2	Mitsui Bank	6.0	Mitsubishi Bank	5.4	The Industrial Bank of Japan	3.0
NISSAY	3.8	Fuji Bank	4.7	Meiji Life	4.0	NISSAY	2.8
Matsushita Elec	3.6	Bank of Tokyo	4.0	Mitsubishi Trust Bank	3.6	Meiji Life	2.0
Kubota Steel	2.6	Mitsui Life	3.8	Tokio Marine	3.1	Fuji Bank	1.8
Sumitomo Chemical Industry	2.5	Taisho Marine	3.2	Mitsubishi Heavy ESOP	2.9	Dai-ichi Life	1.8
Asahi Kasei Industry	2.1	NISSAY	2.5	NISSAY	2.6	Mitsui Trust Bank	1.8
〈Foreign〉	0.2	〈Foreign〉	1.0	〈Foreign〉	3.2	〈Foreign〉	1.2
Top 6 shareholders (%) total	19.8	Top 6 shareholders (%) total	24.2	Top 6 shareholders (%) total	21.6	Top 6 shareholders (%) total	13.2

Toyota Motor		Nihon Yusen		Hitachi, Ltd		NEC Co.	
SMBC	5.0	Tokio Marine	5.8	NISSAY	4.2	Sumitomo Life	8.7
Tokai Bank	4.9	Japan Securities	5.7	Dai-ichi Life	2.7	Sumitomo Bank	6.3
Sanwa Bank	4.8	MHI	4.7	Meiji Life	2.6	Daiwa Securities	4.9
Toyoda Industries	4.4	Meiji Life	4.5	Hitachi Group ESOP	2.5	Sumitomo Marine	3.5
NISSAY	3.8	Mitsubishi Bank	3.5	The Industrial Bank of Japan	2.4	NISSAY	3.4
LTCB	3.5	Mitsubishi Trust Bank	3.5	Sanwa Bank	2.2	Dai-ichi Life	3.4
〈Foreign〉	0.6	〈Foreign〉	0.5	〈Foreign〉	11.2	〈Foreign〉	2.1
Top 6 shareholders (%) total	26.4	Top 6 shareholders (%) total	27.7	Top 6 shareholders (%) total	16.6	Top 6 shareholders (%) total	30.2

Source: Excerpt from the 1980 Kaisha Shikiho, New Year issue

While the so-called "Japan Miracle," period of the 1960s and 1970s came to an end, and with the joining into the global trade, Japan started to get hit hard by the waves of the global economy. In particular, the Plaza Accord of 1985 brought a major shock to Japan as a whole, resulting in a recession with a strong yen. In response to the recession, the Bank of Japan lowered the official discount rate from 5% to 2.5% on five separate occasions in just 14 months from January 1986, and this is regarded as the first macro-policy factor that triggered the bubble creation. At the time, Japan was faced with a trade imbalance with major Western countries and was being politically pressured to accommodate its domestic economy to boost imports, which resulted in overly accommodative “bad” policy judgment in hindsight.

However, I personally believe that it is important to similarly discuss the background of the bubble creation in conjunction with the corporate side behavior since the weak governance structure based on cross-shareholding and internal supervision actually worked in favor of “jump on the bandwagon” behavior altogether without sincere consideration. For Japanese who are now in their 60s or older, the bubble economy is still remembered in various ways with sour feelings, so it is unnecessary to go into details, but I will describe briefly in relation to our critical view on cross-shareholdings.

First, the dominance of the corporate banking sector, which at that time played the most important monitoring function in a cohesive corporate group, was losing its influence, especially among large corporations, due to the evolution of direct financing (capital) markets represented by corporate bonds. The rise in real estate prices due to lower interest rates was a phenomenal opportunity for banks to regain their lost power by providing easy loans to companies going into those developing projects, and the rest is…history. “Bank-based corporate governance control” was still the mainstream at the time, and there were of course no governance oversight functions from the banks' creditors (i.e., widespread depositors), and banks' shareholders were carefully made up by group companies. There was no backstopping in fostering the bubble, especially for those banks.

Furthermore, the companies themselves lacked an understanding of the cost of capital. They were able to raise funds at an overwhelmingly low dividend yield (1.2% on average from 1980 to 1986) relative to long-term interest rates and that drove them to easy equity financing. Undeniably, the absence of a proper corporate governance structure was a factor in the suicidal spiral that led the company to issue stocks and pour such money into real estate development or speculative equity investments that had nothing to do with its core business.

However, whether better corporate governance structure in place would have curbed diffuse corporate behavior is an unanswerable question, and I also agree it may not have been so, given the prevailing social atmosphere of the time. However, even if that is so, I also believe that, at least theoretically, firms with less cross-shareholdings as well as larger owner-operator control would have been more cautious to protect shareholder value, and be more sensitive to external risks.

Finally, if we only focus on superficial phenomena at the time of surge in real estate bubble and stock prices, it looks as if the whole event was a Japan specific thing. However, if we place a layer of "managerial revolution" it starts to rhyme with the US phenomenon of the M&A boom and conglomeration of the 1960s in terms of developmental paths. In the US at the time, the means to keep up with rising asset prices in an inflationary environment was the acquisition of undervalued companies with large assets, while in Japan, it was real estate investment and stocks such as "waterfront names[8]". As mentioned in previous Chapter, in the US, the pendulum swung back in the form of a shareholder counterrevolution swiftly, but it is interesting that in Japan, although the pendulum swung back to some extent with the burst of the bubble economy, it is still far from the level of the US even after 30 years from the bubble burst.

8. Tectonic Shift of Digitalization and Sinking of Japanese Companies

Although it is difficult to point out a direct link, the influence of this cross-shareholding ownership structure cannot be completely ruled out because it is also a remote cause of the lack of agile responsiveness of Japanese companies in the global digitalization process. Here, in this chapter, I would like to share my personal views on this issue briefly.

The characteristics period when Japanese companies, especially electronics manufacturers, dominated the world electronics industry, was an era of "analog technology", a nostalgic symbol of the 20th century. As detailed in Akira Nakano's "The Complete History of IT: 250 Years of Information Technology" it can be said that Japanese companies had the characteristic of being extremely flexible in

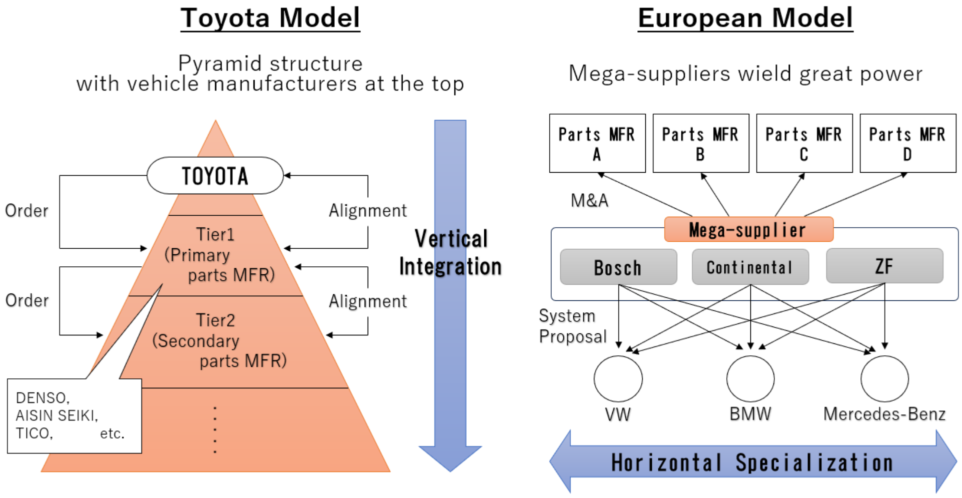
[8] Stock of companies owning large plot of land around Tokyo Bay area, regardless of their actual businesses, were in huge favor from speculative investors including corporates.

responding to the evolution of the times. The characteristic of analog signals, in contrast to digital signals, is that they are "continuous waveforms". Digital signals are "discrete" signals expressed in units of "0" and "1" bits. The history of analog technology is long, started from the desire to communicate by putting voice over communication lines and evolving through the stages of telephone, radio communication, and television broadcasting. This technological evolution has helped human society with better means to communicate but has also contributed greatly to the evolution of corporate decision-making and collaboration methods.

What became important in such era was hardware, such as stereo, television, telephone, fax machine, and various other hardware. Japanese companies excelled at adapting and improving such systems which has been advanced by the west in the 19th century. This “adapting-and-improving” area is where cross–business collaboration demonstrates enormous power –which has been discussed in Chapter 4.

Although the basis is slightly different from the Zaibatsu-type “horizontal” cross-shareholding relationship, the "Keiretsu system, 系列" which developed during Japan's rapid economic growth, had a similar effect (Figure 12). The automobile and electronics manufacturers are central to this system. They followed a unique development path different from the former Zaibatsu groups, but as shown in Figure 10 in Chapter 7, their shareholding structure was also solidly formed by the major banks of the time (but from various groups due to the need for large capital funding). In addition, the major parts producers under Toyota, for example, were controlled by Toyota's direct and indirect holding to create sufficient linkages and coordination. The following figure contrasts the production system based on collaboration/coordination with the European system.

Figure 11: Toyota and European automobile production models



Source: Weekly Toyo Keizai, April 29, 2017

The world-famous just-in-time production system was a masterpiece of the analog era, of which researchers and engineers from many different companies worked together in simultaneous-coordination (and sometimes in sacrifice) to make the production system as continuous as the blood stream in the human body. In fact, US auto companies developed a similar vertically integrated system although not as tightly knit as Japan, whereas the European model has historically followed a horizontal division of labor.

As evidenced by the spin-off of the EV division of the parts giant Continental in 2021, global automotive industry is currently going through the storm of digitalization. Prior to this, more than 20 years earlier, electronics industry had dramatic transformation. The meaning of creating the best hardware to suit various signal formats based on extremely sophisticated tacit knowledge became obsolete in the last 20 years of 20th century. Many would agree that the greatest invention characterizing the digital tectonic shifts was the World Wide Web (WWW), which began in the U.S. at the end of the 20th century. The emergence of the WWW in the 1990s, when multimedia PCs with high performance were becoming popular, made it possible to exchange almost all information digitally, without converting from analog to digital each time. Then, with the advent of the iPhone in 2007, the digital world completely dominated people's lives.

In the digital age, information is flat-and-accessible, and large volumes of data are easily transmitted without time or information loss, division of labor/role based on modularization with clear division in responsibility becomes far advantageous compared to soft-collaboration-coordination model. A good example is Taiwan's TSMC, founded in 1987, which became the world's largest semiconductor foundry company. While its success is hugely attributable to the grand vision of its founder, Morris Chang, his vision was exactly that "division of role" enabled by digital information will suit the foundry model as opposed to vertically integrated and group collaborative Japanese Semi-conductor manufacturing model. Interestingly, the Taiwanese government made this possible, bringing him back from his career in the US, and endorsing him with power and capital in a top-down fashion so that he will be free from old-school minded influences.

As you know, the mentality of collaboration and coordination is a good framework in making incremental improvements but tends to be protective when faced with new ideas and fundamental changes. With such instincts, and if the board of directors, which are collective decision-making bodies, were made up of people with similar positions, backgrounds, and ideas, and if there were a solid mutually protective ownership structure to reinforce this, there is an extremely high chance the judgment from such body will "avoid" dramatic changes since disruptive change is something detrimental to the original idea of continued coordination.

In Chapter 3, I mentioned that the development of capitalism in Japan during the turbulent time in Meiji Period (1868 – 1912) was led by the ownership-type managers represented by Eiichi Shibusawa and the employment-type professional managers represented by Hikojiro Nakamigawa. It was a time when there was no cooperation, and the competition was eat-or-be-eaten. It was a continuous struggle for one's fortune and life, an era in which a sense of business, energy, and ethics came into play.

As an investor, I am happy to see that more and more Japanese companies are now embracing with self-criticisms, strengthening their offensive governance tactics, and reviving their businesses. But still, looking at the past 30 years, it is true that emerging companies that were not dependent on cross-shareholding structure has shown more remarkable growth in general. Keyence, now one of Japan's top 10 companies by market capitalization, was listed in 1987, and Fast Retailing was listed in 1994, with no heavy baggage in their respective shareholding structure but with strong ownership mentality. There has been almost no academic research studying and comparing companies on exercising of strategy in the age of digitalization from the viewpoint of ownership structure and its governance process, and I look forward to future research of this area in academia.

9. Continuation of Past Ownership Structure and Footsteps of Rapid Change

I have discussed from various perspectives how the cross-shareholding structure had a positive impact in one time but has had a negative impact as the times have changed, based on various historical facts and academic discussions. However, the big question is why the cross-shareholding structure still remains today in the form of "policy shareholdings" and "stable shareholders,", even though its role in the era has ended, and why, 30 years after the collapse of the bubble economy, the shareholder counterrevolution has yet to take place in the capital market in Japan. Unfortunately, I do not have an obvious answer to this question.

Similarly to the Meiji Restoration moment in 1868, the collapse of the bubble economy was, in a way, a wonderful opportunity for major social scrap-and-build and a chance to revive Japan. Many large companies went bankrupt during the severe bad loan problems, and large foreign funds entered the market one after another buying Japanese companies in distress. However, the corporate society as a whole did not have the guts to change its governance and management systems in general, including the cross-shareholding structure. It is a big shame that GL and ISS, the voices of the outside world, had to speak out NOW to pressure this change, which is evidence of lack of self-transforming capability among Japanese companies. Sadly, I feel that the deep understanding of ownership and control disputes has been confined to academics in their studies and have not been fully discussed and digested in the business world, especially at the management level. In my view, most of the corporate managers have regarded the rise of “activist investors” in Japan as superficial phenomenon and reacted only tactically without thinking much about the history of such formation and vulnerable trend of the future shareholding structure.

However, the clock is ticking fast and time is irreversible. We will discuss two points here to show you the evidence of why we feel so: (1) changes in ownership by Banks and (2) changes in employee loyalty.

(1) Changes in ownership by Banks - BIS regulations and banks

One of the key players in Japan's rapid economic growth during the Showa period was the mega banks as both mentors and watchdogs. As the banks were at the core of each corporate group, their policy shareholdings, a symbol of unity, were “perceived to be” necessary to maintain the system and traditions. However, with the bursting of the bubble economy in the late 1990s, the cross-shareholdings began to crumble, since those banks capital adequacy have seriously deteriorated by the bad loan problem and had to start monetizing for themselves to survive. Tightening of regulations by Bank for International Settlements (BIS) regulations also fueled this trend.

Among the recent regulatory changes, the tightening of capital adequacy rules by BIS from the perspective of preventing a recurrence of the financial crisis and enhancing the risk resilience of the international financial system has had major impact to Japan. In March 2017, the final version of the capital adequacy rules, Basel III, was agreed. This took the form of enforcement actions sequentially implemented in various countries from January 1, 2023. In Japan, on April 28, 2022, the Financial Services Agency (FSA) published the "Notification of Amendments to the Capital Adequacy Rules for Banks (Finalized Version)" and other related documents based on the final Basel III agreement to comply with Basel III. Various risk weights (RW) for risk assets were raised, and for equities, the RW was to be raised from the current 100% to 250%.

As a result, banks had to start reducing their high RW assets and could no longer protect their policy shareholdings. As shown in Figure 12, since Basel III was implemented, Japan's leading mega banks have hastily announced their policy to reduce their policy holdings one after another, and Sumitomo Mitsui Trust HD, in particular, shocked the market on May 2021 by announcing its aim to sell all policy shareholdings.

Figure 12: Cross-shareholding unwinding plan by major banks

Name	Holdings (B/V) (JPY:Billion)	Progress and future developments	Reduction target (JPY:Billion)	Target period
MUFG Bank, Ltd. (incl. Mitsubishi UFJ Trust and Banking Corporation)	1,850	In FY2022, it sold approximately JPY 154 billion of cross-shareholdings; it aims to sell JPY 500 billion of cross-shareholdings in the three years from FY2021 to FY2023.	500	FY2023 end
Mizuho Financial Group, Inc	997	The balance, which was nearly JPY 2 trillion at carrying amount at the end of March 2015, was halved to about JPY 1 trillion at the end of March this year.Over the next three years, the balance will be reduced by JPY 300 billion, bringing the balance to less than 20% of net assets at market value.	300	FY2025 end
Sumitomo Mitsui Financial Group, Inc.	1,150	JPY 180 billion in the three years to 2022, based on a five-year reduction plan of JPY 300 billion (2020-24). The plan is to reduce JPY 200 billion over the next three years. The aim is to reduce the balance to less than 20% of net assets in the next medium-term plan period.	200	FY2025 end
Sumitomo Mitsui Trust Holdings, Inc	500	A total of JPY 142.6 billion (based on Carrying amount) will be sold over the five years from FY17 to FY21; JPY 150 billion over the three years from FY23; and eventually all of the approximately JPY 1.4 trillion will be sold.	150	FY2025 end

(Note) The book value of holdings is based on FY2021/3 for MUFG and FY2022/3 for others.

Source: Prepared by Hibiki based on each company's financial results briefing materials for FY2023/3

This BIS trend seems to be happening from a completely different perspective from the governance and ownership structure issues we have been discussing. But come to think of it, this "too big to fail" big banks regulatory framework was brought in since corporate governance protocol for major banks in the US was not working and so it is purely a “corporate governance” issue in essence.

(2) Changes in Employee Loyalty

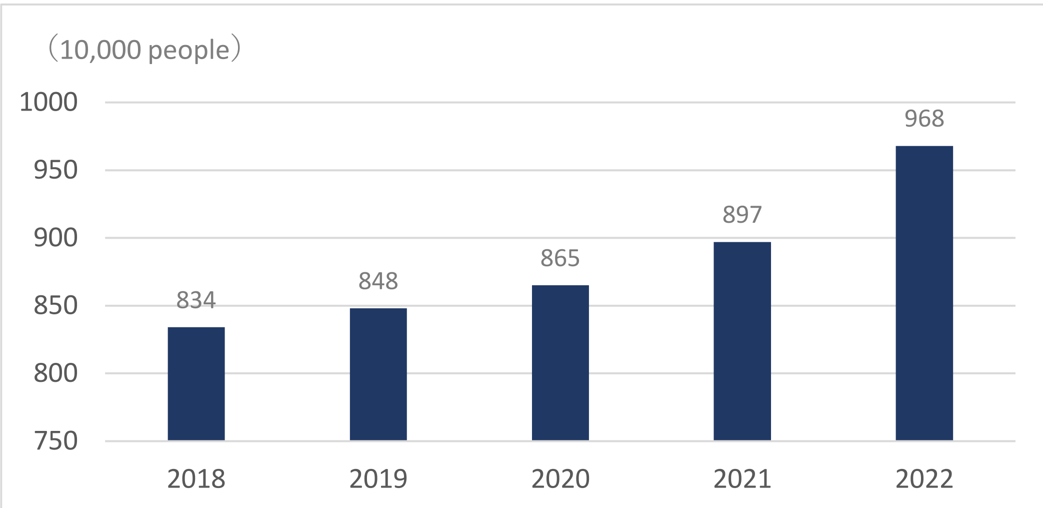
As described in Chapter 4, the very day one original incentive by those corporate managers for initiating the cross-shareholding structure in the first place was to stabilize the workforce to accumulate technology within the company – leading to “lifetime employment”. This was a symbolic characteristic of the industrial capitalism era, in which "company specific technology" was valuable. Thanks to such technological accumulation by predecessors, many Japanese companies are now recognized worldwide as still one of the best in the industries such as machinery, precision parts and semi-conductor equipment.

However, in two ways, the original concept of lifetime employment that the "early" cross-shareholding structure tried to protect has become completely outdated.

First, as we discussed in Chapter 8, we have entered a digital age which technological advancement can no longer be achieved within a company or within a small group but require global network. For companies to achieve higher goals, they need to head-hunt talents from other companies who can communicate freely in the global network and go through tough negotiations with various people around the world. Home grown talent is wonderful but maybe not sufficient or well trained to swim in the ocean. Developing an organization and a pool of next-generation executives who can be entrusted with steering the ship in this fast-moving world has become extremely difficult. In this environment, it is necessary to acquire human resources from other companies in mid-career based on the fact that a certain amount of people will flow out to other companies.

Second, as shown in Figure 13, the number of people interested in changing jobs has increased dramatically to nearly 10 million people in recent years, far exceeding the 3 million people who changed jobs annually in the past few years. From the employees' perspective, spending one's entire life at a single company is no longer natural even in Japan. In a networked oriented world, changing jobs to acquire or enhance needed skills has become an important means of building a good career for younger generations. It is sad from the perspective of corporate managers, but a cold reality that we all need to face.

Figure 13: Number of people interested in changing jobs (2018-)



Source: Compiled by Hibiki from the Ministry of Internal Affairs and Communications' Labor Force Survey.

Thus, the banks that have been central of the cross-shareholding have turned to divestment phase, and the concept of securing human resources, which the cross-shareholding was supposed to protect in the first place, has also changed…

To add to that, "managing business from a long-term perspective" that cross-shareholding structure aimed worked extremely well for a certain period as we discussed earlier. It also exposed the fact that "risk taking governance protocol" to react quickly to landscape changes was seriously deteriorated by it too. Today, it has become difficult to list good reasons as to what exactly the advantages of cross-shareholding shares are to increase the value of a company. In other words, cross-shareholdings, policy-shareholdings, or stable shareholding have lost much of their "proper" meaning other than providing "easy yes vote" for existing management, and the banks, which had been center of these, started to step down slowly from their positions with the excuse of BIS regulation tightening.

10. Six Suggestions: From Cross-shareholding to a Constructive Shareholder Base

All previous chapters have been both an affirmation and a denial of past Japanese capitalism from different angles. In this final chapter, I offer my suggestions to you as an investor. I would like to emphasize that with due respect for Japan's past economic and social success, I also had to point out various unsolved problems to be constructive and to face the future together.

Now, since cross-shareholdings will disappear soon (in our view), there will be two types of companies: those that actively consider and implement how to attract shareholders by business and management strategy to maximize corporate and capital market valuations, and those do not take any action. The following are six suggestions for companies that take a proactive approach. I, as an investor, do not believe that all companies would need to take a proactive approach or would have the capability to do that. Those who don't want to face it should seek to exit public capital markets by either M&A or Management Buyout deals. It is nothing to be ashamed of to do so. Please do not keep the status-quo since such judgment won't benefit your employees or your business partners even if it may benefit yourselves until your retirement. Here are my suggestions:

#1: Let Management and employees own large sum of your shares
#2: Buy back your shares as much as you can
#3: Attract "active" Institutional Investors
#4: Turn retail individual shareholders into fans
#5: Proactively accept foreign shareholders
#6: Acquire other companies and proactively generate synergies

#1: Let management and employees own large sum or your shares

The separation of ownership and management is inevitable in the development of a capitalistic society and the trend towards successful enterprises becoming larger. To minimize this agency problem, there is nothing unethical about people involved in the management of a company obtaining the benefits of their own success in the form of increase in wealth due to increase in the value of their company shares, as we have outlined with the General Motors (GM) example in Chapter 5 of our 2022 Yearly Letter "Management commitment (Japanese)" (link). It is quite reasonable for GM (in the example) to buy back its shares and grant them to its executives and employees in a spirit of **"buy from those fools"**. There are also tax advantages to granting stock-based compensation and treating it as a severance package.

#2: Buy back your shares as much as you can

Sale by policy shareholder will naturally pressure the share price negatively. Although it is possible to absorb such pressure by placing to institutional investors who understand the company well and are likely to hold them from a long-term perspective, the priority (except in the case of insider deals such as M&A) should be to absorb them as share buyback since time is money and sale cannot wait. As you well know, such acquired treasury shares can be used for stock-based compensation as described in recommendation #1 or as a currency for M&A (in the form of stock swap), and if there is no immediate need for it, you can just cancel it! Share buybacks have increased in response to the TSE's call since the beginning of this year. Some argue that they are going a bit too far but we do not feel so. Share buyback should be done if the ROI of investing in buying back your shares is higher than your projects - period. However, if the decision is not based on "a comparative analysis of risk-return with business and strategic investments," that is a corporate governance problem (or a financial literacy problem). If market assigned cost of capital is too high compared to what management believes the cost of capital is, then the company should buy its shares and communicate to the market that the discrepancy is too large.

#3: Attract “active” Institutional Investors

As mentioned in Chapter 2, the trend toward passive investing is an inevitable trend, and this has led to an increase in the influence of voting advisory firms with a global presence. It is an extremely important perspective to "induce the entire institutional investor base into supportive shareholders" by being aware of the advice from advisory firms. But unfortunately, passive investors, by their very nature, are not interested in the fundamentals of your business, and they trade according to their capital inflows and market trends. This is why institutional investors who make “active” investment decisions based on fundamentals are your nice partners and cheerleaders. Naturally, the suggestions of advisory firms are one axis of judgment even for fundamental institutional investors, but there is an increasing number of cases where they exercise their voting rights based on their criteria; furthermore, as mentioned above, when they judge that "the stock price has fallen such that is undervalued as market is short-termed," they will buy and support. However, judging from what has happened already in the US, ALL institutional investors will likely more or less become “activist shareholders". As a precondition, stated in Principle 4 of the Governance Code, the board of directors must demonstrate to investors that "appropriate risk-taking" is in place in the business management protocol. In order to make institutional investors your friend, you do need to commit to high-standard corporate governance setting for sure.

#4: Turn retail individual shareholders into fans

After the bursting of the bubble economy in Japan, the notion of stock investing for personal wealth creation was completely crushed, and such is still the case. However, as exemplified by the introduction of the "New NISA," the trend away from savings and toward investment has also been gaining popularity from a policy perspective. Due to these accommodative policies, there is a high chance that the number of individual investors entering the stock market will increase. Unlike institutional investors, individual investors do not need to explain their judgment to others and often demonstrate emotional buying which tends to support companies as long-term fans rather than short-term price chasers.

Especially for B2C companies, the possibility of inviting the fan base to become shareholders is extremely high. It is in the company's best interest to return to the basics and meet the expectations of its fans by increasing corporate value (income gain and capital gain!). It is also expected that due to their wealth effect (by increase in share price), purchasing power will also increase to support the business. For example, P&G (Procter & Gamble), a major US household goods manufacturer, institutional investors own more than 60% of outstanding shares, which indicates good diversification already, but retail individual investors also own about 35%[9] which means a huge fan shareholder base supports its stock price.

#5: Proactively accept foreign shareholders

Foreign investors are the largest owners of TSE stocks by investor category, owning approximately 30% of the total. This ratio has been rising almost consistently over the past 40 years, and it can be said that they have already played a role as a recipient of cross-shareholdings that have been unwound. In this context, managing a public company without thinking of foreign investors is impossible. Foreign investors are almost all institutional investors, and in many cases, the people who are on the frontline of investing are Japanese nationals, so it is almost becoming meaningless to categorize them as foreigners. The key question you need to ask yourselves is, who will be the structural buyers when domestic cross-shareholders are unwound?

Japan's pension fund will shrink in the future, due to the aging population. There are certain expectations for expanding the individual investor base, but practically speaking, ETFs and investment trusts will be the main purchasing channels rather than individual stocks unless they have strong feelings toward individual companies. Although there is a higher chance that foreign investors will become more passive, foreign investors are certainly the ONLY people who have the structural capability to acquire shares in Japan due to global increase in wealth. If some management team thinks that "our foreign ownership ratio is low so it doesn't matter!" this is a completely wrong approach from the long-term perspective since the bulk of your stable shareholder base may disappear in due course. Management should understand that the low foreign ownership ratio IS the problem, and the company must recognize the urgent need to translate its Investor Relations materials and financial statements at least into English. This is

[9] https://www.nasdaq.com/articles/heres-what-the-procter-gamble-companys-nyse:pg-shareholder-ownership-structure-looks-like

a point we emphasized in our July 2022 letter to TSE: We are very much aware that the TSE also feels strongly that companies should promptly translate their financials and IR material into English judging from their publications.

#6: Acquire other companies and proactively generate synergies

I fully understand that M&A is very difficult to handle, but nevertheless I offer this as my final suggestion. Although this suggestion comes from a different angle from the viewpoint of dealing with shareholders as mentioned in my earlier suggestions, I believe it is a necessary mindset given the direction of the capital market over the next three to five years.

The challenges listed companies face are increasing dramatically, including pressure from the TSE, increasing hurdles from voting advisory firms, ESG perspective tasks, and the globalization of investors etc… With daily management issues also piling up, check list to be maintained as a listed company will become even detailed and complex. Undoubtedly, it will be difficult to face these challenges if Investor Relations work is as “passive” as in the past. As a listed company, it is necessary to allocate more resources and energy to this area than ever.

Under such circumstances, it is not difficult to imagine that many companies will be forced to consider M&A or to go private since being public is becoming such a pain. While such “lazy” companies have always existed in the industry, now, they cannot get away in this severely changing market environment. If companies diligently implement my suggestions 1 through 5, it will likely lead to a better valuation and recognition from market and will be beneficiary when acquiring other companies. In addition, as discussed in the US case in Chapter 6, an increasing number of companies will likely seek to sell off their affiliated businesses or business divisions to increase corporate value through “focus” strategies. Daring to take advantage of changes in the market structure and taking "appropriate risks" as a company is one of the conditions for "good management" which would lead to appreciation from sophisticated constructive shareholders.

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Based on my view that cross-shareholding, or in other words policy shareholdings will disappear over the next several years, I have made above six suggestions so that you can face your own future and try to maneuver it. These suggestions are not far-fetched and actually quite standard. However, throughout the chapters, I have explained the deep background and reason for these suggestions. In fact, these are suggestions for all listed companies in Japan, and it is up to each company to be aware of the issues and be able to implement them. Japanese companies have lost their shine after the bubble burst in the 1990s and so did Japanese capital markets global presence. The road to recovery, if any chance, depends on the effort by corporate managers and sense of urgency by them to improve corporate governance standards. For those management teams who feel that things I mention is easy and that they are already being implemented, fine, but please push further. And for those who have not started, it is the last chance for change.

EOD

Aug. 26, 2023

(English translation published on Sept. 14, 2023)

Appendix

Drucker, ″Management – Issues, Responsibilities, and Practices″ (1974). Excerpts from the Preface to the Japanese edition

This book argues that there is no fundamental conflict between management's ″social responsibility″ and ″profit″. On the contrary, if management fails to recognize that ″securing profit″ as its primary social responsibility, it is a misperception so definitive that it calls into question the qualifications of management. …….. Profit is not just something that business owners and investors ″want,″ it is something that the entire economy and society needs. Incidentally, even communist societies need profit as much as capitalist societies. …….. In a society, at any given point in time, about two-fifths of all enterprises in the society will fall undermaking a loss. And one-third of all enterprises usually manage to remain profitable. Therefore, profitable enterprises are always destined to have to cover the deficit, which outnumbers them. …….. It is irresponsible to think, as Americans have in the past, that ″profit″ is something only investors and corporate executives pursue. But it is also irresponsible to avoid thinking of it as a ″dirty term,″ as many Japanese and European business executives do. ……… While the manager is responsible for the impact of his company's activities on the external natural environment and on social life, he is also, though not primarily, responsible for the conservation of the economic resources under his control. The conservation of economic resources can be thought of as the minimum ″profit″ to meet the needs of tomorrow. The failure of business managers in many countries to understand this is, in fact, is one of the most important reasons why confidence in management is in free fall and pressures management face. Emphasizing profitability as an indispensable part of a company, or ″cost″ in the true sense of the word, is one of the constant themes throughout the book.

If Eiichi Shibusawa taught us anything 100 years ago, it is this: managers have responsibilities. But their primary responsibility is economic. Only by fulfilling it well will they be able to address their social responsibility, especially their social responsibility to the external environment, of which we have become increasingly aware over the past few years.