Cultivating Conscientious Stockholders

By Kagono Tadao

Focus Shifts from Theory on Stockholder Rights to Stockholder Responsibilities

There has been much debate on stockholders' rights, but little has been said about the responsibilities of stockholders. This is probably because a overwhelming number of past cases involving corporate governance have dealt with infringement upon stockholders' rights. Among corporate governance researchers, the pervasive view is that company management should rightfully be based on the will of stockholders. Some economists and commercial law scholars regard corporate governance merely as management on behalf of stockholders. However, the question of whether it is in a company's best interest to comply with its shareholders' wishes requires prudent consideration. Business scholars who have studied the history and the present state of corporate governance in Japan and the United States hardly agree that fulfilling the will of stockholders leads directly to effective management. In fact, cases of corporate management failure as a consequence of compliance with shareholders' will are not uncommon both in Japan and abroad. In the early Showa era (1926-1989), some companies were unable to maintain control of their productivity because their shareholders received dividends that were not based on profits but on the sale of corporate assets. Witnessing this trend, Takahashi Kamekichi was prompted by a sense of crisis and issued a warning in the form of *Kabushikigaisha Bokokuron* (Theory of National Destruction Spurred by Stock Corporations). In the United States, short-term management conforming to stockholder desire was practiced from the 1970s to 1980s, and as a result, the country lost its competitive edge. I believe that one reason for the recent flaws in Japanese corporate governance is the overzealous willingness on the part of companies to appease shareholders. Of course, this is not the only reason.

The Objectives of Corporate Governance

It is my opinion that the fundamental objective of corporate governance should not only be the protection of stockholder interests but also the promotion of effective management. To promote effective management, a company's leaders must have the intelligence to judge the worthiness of each appeal made by shareholders and other vested entities. However, this type of judgement is possible only when a company's management has some degree of independence from its shareholders. As stockholders boost their clout, not only management's responsibilities, but their own responsibilities as well are required to be taken into account. Unfortunately, commercial law scholars have not presented theories on stockholder responsibility. As far as theories go, about all we have seen pertains to the protection of small shareholders' rights achieved through limitations imposed on major shareholders' rights. What we need is some serious debate on the subject of stockholder rights and to what extent they can be limited to promote successful corporate management.

In considering the sovereign rights of limited liability stock company shareholders, it is important to distinguish them from the sovereignty of the people in national politics. In the latter case, it is the act of participating in public policy that is significant, whereas, with a stock corporation, a shareholder's participation alone bears no real meaning. It is essential that participation promotes good management and contributes to the wealth creation and profitability of the company. The reflection of shareholder will in a company's policies alone, regardless of the type of result it may yield, is not sufficient justification.

Undue Stockholder Rights Distorting Corporate Management

It seems natural for a person to invoke his proprietary rights with regard to a possession. Proprietary rights are fundamental to modern society and should be respected; however, they are not absolute. In the days of the bubble economy, a wealthy individual who had bought a rare painting made the distasteful claim that the painting would be placed in his coffin and buried along with him at the time of his death. If the property is of a public nature, the owner's rights should rightfully be framed by social limitations. Corporations are like valuable paintings, and in fact, they are even more public in nature. In the case of such a public entity, the owner may not, at his own sole discretion, practice his will. There is a justifiable reason why the owners of a corporation, in other words, the stockholders, should be even more limited in their actions than the owner of a priceless painting. The reason is that the weight of stockholder responsibility is not as great as that of general ownership.

Stockholders only bear limited liability with respect to a corporation. They are not liable for any portion in excess of their invested share. It is because responsibilities are diluted in this manner that so many can own stock with peace of mind. The stock corporation system provides limited liability stockholders powers so great as to be called unwarranted by some. These conditions exist for the protection of the stockholders as well as in order to

Photo: AP/WWP

The U.S. dollar fell against the Japanese yen in Tokyo on Jan. 9, 2003

attract investors. After all, a capitalist society needs investors who contribute the money that defrays the risks of corporate business. To attract such investment, investor responsibility must be curtailed, and at the same time, investors must be given a generous set of protected rights. Looking back at the history of stock corporations, stockholders were victims in a overwhelming number of cases. This can be regarded as one of the reasons why stockholder rights, rather than responsibilities, have been the focus of theory.

In view of recent accounting scandals such as those involving Enron and WorldCom, it is clear how weak shareholders are and how easily they can be deceived. Yet the overall percentage of cases in which companies resort to unlawful methods to cheat their investors is very small. And other kinds of problems arise when a system is established to protect the stockholding victims of these few instances and is applied to corporations in general. A case in point is the problem of excessive stockholder rights and the adverse effects brought upon corporate management by this sort of undue power. In recent times, we have witnessed the abuse of such stockholder rights at Tokyo Style Co. The method used was very similar to that which had been employed by Greenmailer in the United States. However, the Tokyo Style case is one that was instigated by a group of stockholders with extraordinary ideas, and it does not carry serious implications. In fact, most of the stockholders realized the anomalous nature of the group's demands and reacted rationally.

Issues of Institutional Investors

The excessive power of stockholders is especially troubling when institutional investors are involved. In Japan, the percentage of shares held by institutional investors, particularly those overseas, is on the rise, and this issue is becoming increasingly crucial. The following explains why institutional investors may be hazardous to the overall healthy development of corporations.

First of all, institutional investors play an influential role in setting stock prices on the market. Originally, the market was a crossroads where various perspectives and ideas converged. A market that can efficiently allocate resources is one in which none of the participants can influence pricing by themselves. The stock market, however, is not such an establishment. In the stock market, the influence on price setting exercised by institutions that move large sums of money is enormous. It would be fair to say that the voice of the market is not the voice of the general buying public, but rather the voice of institutional investors. Concerned with stock prices, corporate managers cannot ignore the intentions of their company's institutional investors. The managers of Japanese companies for which institutional investors hold a high percentage of shares are, in fact, hosting investor relations meetings in New York and London for overseas investors. In addition to the information imparted by the management, institutional investors are invited to share their intentions at these meetings. Institutional investors whose shareholdings have grown too large find it difficult to sell their stock as an expression of protest. So instead, institutional investors are beginning to exercise their influence over corporate management. As a result, institutional investors have gained substantial influence over corporate managers. Nonetheless, institutional investors' exercise of power has an adverse effect on corporate management.

This occurs because the objectives of institutional investors differ from the executives of corporations. The initial priority of interest for institutional investors is not the advancement of good corporate management. It is the

potential for increased value in their overall investment portfolio.

One must also be cautious of the differences in logic that exist between institutional investors and corporate managers. Institutional investors' reasoning is based on their own particular community's logic, which clearly contrasts with the logic of creating solid management. A credit rating firm once cited Toyota Motor Corp.'s adherence to a lifetime employment policy as a reason for lowering the company's rating. If this can be defined as investor logic, then we must conclude that this logic is at odds with the logic of good corporate management. In order for a corporation to succeed, investor logic cannot be ignored, but it is also necessary to consider matters from the employees' perspective. The management of a corporation requires two resources: capital and labor. The difficulty of management is that tactful compromise must be brokered between investors and labor logic. Efficient management cannot be accomplished if the logic of either side is neglected. At one time in Japan, some corporations lost their dynamism because they were overly concerned with labor's needs. As a result of this philosophy's failure, there are some who strangely theorize that the will of capitalists should come first, but this too is wrong.

Institutional investors are not committed to the promotion of business in the long run, though I am not suggesting that all of them are short-term investors. Among institutional investors, there are those who invest in pension funds. These investors would, under normal circumstances, be considered long-term. Still, because pension fund managers are evaluated on the short-term performance of their product, institutional investors' vision tends to be shortsighted. Other institutional investors are more firmly ensconced in their short-term ways. One reason is that setting their sights on immediate goals gives them greater control over fund managers. Furthermore, in the financial world, this tendency is not problematic because, in many cases, optimal short-term results add up to optimal long-term performance.

This type of short-term vision on the part of investors may have a negative influence on corporate management. Investors inevitably try to encourage management policies that will produce short-term rewards, even if adverse effects are anticipated in the long run. Short-term investors take the opportunistic approach of selling out early and leaving the long-term losses to be dealt with by other investors. A typical outcome of this type of problematic scheme is mass layoffs. Layoffs slash labor costs in the short term, but they also reduce labor morale in the corporation as well as employee loyalty. Stock options breed similar issues. In the early stages, stock options are effective; however, in order to extend those effects beyond the short term, it is necessary to issue more and more shares, thereby creating high long-term costs. The stock option system spawns a plutocratic atmosphere within the corporation, which hurts the corporation in the long run.

Successful corporate governance requires not only short-term considerations, but long-term ones as well. Coordinating the long-term good of the corporation with one's immediate personal agenda is the responsibility of the investor.

Dealing with Institutional Investor-Related Issues

Let us take a look at the ways in which institutional investors can be made to realize their responsibilities as shareholders and take actions that are in the long-term interests of a corporation.

The most fundamental method is to inspire the investor to face up to his responsibilities. Considering the precarious effects which can be caused by stockholders' excessive power, institutional investors are expected to behave in a manner that reflects proprietary responsibility. This is, in effect, beneficial to the stockholder as well. Fund managers of institutional investors are professionals, just as physicians and lawyers are. Professionals do not merely use their expertise to guide their clients toward profit. They have a common code of ethics by which they must abide. This is because the clients themselves do not have the expertise to keep the professionals in check. The basic method calls for a code of ethics to be established and enforced for fund managers. The question is, can fund managers be expected to voluntarily follow such a plan of action? If not, fund managers' actions must be restricted by external means. Alternatively, some mode must be developed in which to mitigate the harm associated with their actions.

It may be too optimistic to expect institutional investors to behave ethically. The popularity of investing in stock can be explained by the fact that people can invest without feeling any responsibility related to their ownership of shares. If ethical behavior cannot be expected, it may be necessary to impose limits on stockholders' exercise of rights. The following approaches merit consideration. The first method calls for expanded rights for long-term investors. It may be beneficial to adopt a system similar to that provided by French commercial law, consisting of broader voting rights for long-term stockholders. The other approach imposes a temporary limit on stock transactions following a shareholder's invocation of voting rights. Doing this can curb actions on the part of opportunistic stockholders who demand corporate policies that have positive short-term effects but are problematic in the long run, and then sell off their shares.

The most orthodox method of moderating the inordinate power of institutional investors involves lowering the degree of corporate dependence on them; that is, to raise the percentage of individual shareholders. In Japan, various policies have been instituted in order to increase the ranks of individual shareholders, but their rate of stock ownership has not risen. If we cannot count on an increase of individual shareholders, we must seriously consider a policy that creates investors willing to make long-term commitments. The Japanese industrial community invented this type of policy. For instance, the

cross-shareholding system is an approach that aims to eliminate takeovers and was effective in reducing the power of those investors who were averse to committing themselves for the long-term. Nonetheless, with the banks facing hard times, maintaining this cross-shareholding system is difficult. Given these circumstances, employees make the best candidates for long-term shareholders.

Promotion of Employee Share Ownership

On this subject, there is a need to observe the trends in the United States. The United States is seeing an increase in the percentage of employee share ownership. In over one-fourth of all American listed companies and companies whose stock is sold on the over the counter market, employee share ownership is at least 15%.

Although there are various reasons for this phenomenon, I surmise that, bucking the trend toward increased institutional investor share ownership, there is now a greater appreciation for investors who are willing to make long-term commitments to companies and who understand corporate culture. However, the employee corporate share ownership percentages in Japan are low. According to a Tokyo Stock Exchange study, employee stock ownership ratios by unit stock in Japanese listed companies average only 1.28 %.

Employee stock ownership plans have a wide range of advantages. To the companies themselves, they offer the prospect of investors willing to make long-term commitments. And along with that comes enhanced corporate governance, benefiting other shareholders as well. Shareholding employees are committed for the long run and are, therefore, very cautious about other stakeholders interests. This is because losses may be incurred in the absence of such vigilance.

There are, undoubtedly, problems that need to be worked out before an employee stock ownership system can be set up.

For one, it is a risk assumed by employees. If employee stock ownership can be coupled with effective corporate governance, the system will raise the stock value in the long term and contribute to employee asset building. However, if the company should fold, the employees will lose not only their jobs but also their assets. Just prior to Mycal Corp.'s bankruptcy, the labor union bought shares in a show of employee solidarity. Soon thereafter, those stocks became mere scraps of paper. It is because of such dangers that employees must take a serious interest in monitoring management's actions. But it is also necessary to give employees some leeway in deciding to what extent they are willing to commit to their company. There should also be a system that reasonably distributes the risks. By establishing an organization that pools each company's employee shares, it is possible to allocate the risks based on the portfolio. And extending voting rights to the employees of the organization's member companies will give the employees a keener perspective from which to observe the management.

Photo: THE YOMIURI SHIMBUN

Mycal Corp.'s labor union bought shares in a show of employee solidarity shortly before the firm went bankrupt in 2001

When employees become the core of corporate governance, there is an increased danger of inner-directed governance, as was experienced in Japan some time ago. The company's employees hold more than half the shares of United Air Lines of the United States, but in contrast, a majority of the elected board is comprised of independent directors representing general investors. Though independent directors may offer advantages to companies diligently trying to develop more effective corporate governance, it is imprudent to conclude that the former is linked directly to the latter.

When designing an employee stock ownership system, it is advisable to heed the lessons learned from previous stock option plan mistakes. The biggest problem related to stock option plans is the temptation to reap a profit from the sale of stock. This does not further the employee's motivation to commit to the company. Instead, what is needed is a means to prompt the stockholder to hang on to his shares. JJTI

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