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The Sôkaiya's Grip On Corporate Japan

By Ogino Hiroshi

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Nomura Securities Co., Japan's largest brokerage house, has been mired in scandal and rumors of scandalous business practices for years. In the latest flurry, beginning in March this year, senior executives and former executives were accused of funneling millions of yen into an account linked to a *sôkaiya* corporate extortionist.

Two former managing directors at Nomura were charged with violating laws regarding investment practices. They were accused of arranging for proceeds from trading in shares of four companies to be placed into a corporate account held by Kojin Building Co., a real estate company run by Koike Yoshinori, 52, younger brother of Koike Ryûichi, 54, a reputed sôkaiya.

Based on statements and mountains of documents, the scandal widened to include Dai-Ichi Kangyô Bank, the nation's third-largest commercial financial institution. Officials of the Tokyo District Public Prosecutors Office and the Securities and Exchange Surveillance Commission determined that the elder Koike obtained billions of yen in loans from Dai-Ichi Kangyô, much of which was entrusted to Nomura to invest on his behalf.

In the turmoil that followed, the Koike brothers were charged with racketeering, and several executives and former executives at Nomura Securities and Dai-Ichi Kangyô were charged with violating laws regarding payments to extortionists and illegal investment and lending practices.

Koike apparently benefited from a VIP account the brokerage firm managed for him. Japan's Commercial Law prohibits companies from giving financial benefits only to selected shareholders. Such special payments violate the principle of shareholder equality: that all shareholders must be treated equitably in proportion to their holdings. It was this kind of favoritism that got Nomura and many of Japan's brokerage firms in trouble in 1991, when they were found to have compensated selected investors for losses incurred when the asset-inflation bubble burst and stock prices plunged. Such payoffs, violating the principle of equality, also benefit sôkaiya, known as *tokushu kabunushi* (special shareholders), who have ties to the underworld. A sôkaiya, which literally translates as a "general shareholder meeting man," holds a nominal amount of stock in a "target company" and threatens to disrupt its annual stockholder meeting unless given hush money in advance.

Nomura President Sakamaki Hideo and the two managing directors resigned in March after the scandal surfaced. A sweep of Nomura management that followed in April brought resignations of Nomura board members, including the firm's five vice presidents and four senior managing directors.

Similarly, when the scandal was found to have involved Dai-Ichi Kangyô Bank,

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the bank's chairman, Okuda Tadashi, its president, Kondô Katsuhiko, and other top-level executives were forced to resign for their involvement in extending the huge loans to Koike without collateral.

In unsworn testimony before the House of Representatives (Lower House) Finance Committee in April, Sakamaki emphasized the illicit transactions Nomura officials had conducted for Koike were made without the knowledge of top-level executives. Under a barrage of questions from Diet members, however, the former Nomura president admitted that Nomura's general affairs department had an association with Koike that went back to the 1970s. Sakamaki was arrested in May.

Another sôkaiya-related scandal came to light in March, involving Ajinomoto Co., the internationally known producer of flavor enhancers, seasonings and processed foods. Ishigami Takao, chief of the general affairs section in Ajinomoto's general affairs department, was accused of handling dealings with sôkaiya, paying them a total of ¥6 million. He is said to have had a budget of as much as ¥100 million a year. He faces charges of violating the Commercial Law along with his boss, Noguchi Yukio, the general affairs manager. As at Nomura, Ajinomoto's top

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brass denied sôkaiya involvement and said the payments had been made without their knowledge. Inamori Shunsuke, the company president, stepped down, however, when the public and shareholders criticized him for his lack of responsibility.

Japan's Commercial Law was revised in October 1982 to prohibit payments to sôkaiya, providing a penalty for violations. That revision, it is said, prompted many companies to rid themselves of these corporate parasites. However, the series of payoff scandals that has surfaced over the past decade or more shows that their efforts have not been entirely successful. In May 1984, the chief of the president's office—the manager of internal affairs for the president and senior executives—of Isetan Co., the department store and retailing chain, was arrested and charged with paying a fee to sôkaiya, the first such arrest under the revised law. In the years that followed, officials of several other leading companies were also charged with breaking the law. These include, in chronological order, department store Sogô Co., photo-film maker Konica Corp., supermarket chain Itô-Yôkadô Co., beer brewer Kirin Brewery Co. and department store Takashimaya Co.—all representative members of corporate Japan. With revision of the law, police and prosecutors' investigators have made a major effort to crack down on violators, hoping to score arrests of big-business offenders to bring home the message. But the illicit relationship between corporate management and sôkaiya continues, with a growing list of corporate offenders that now includes top executives in the securities, banking and foods industries. In fact, corporate fear of sôkaiya extortion remains deep and widespread. The following example illustrates some of the reasons why. It is drawn from observing the shareholder meeting for Nippon Telegraph and Telephone Corp. (NTT) in Tokyo on June 29, 1994.

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The annual meeting of Japan's largest stock company opened at 10 A.M. in a huge reception room that seats 2,800 at the New Takanawa Prince Hotel, near Shinagawa Station. On the same day, 2,008 companies across the country held their *kabunushi sôkai*, or annual shareholder meetings, according to the National Police Agency.

As I entered the room, I was struck by the fact that all front seats close to the podium were taken while about 30 percent of the remaining seats were open (1,942 shareholders attended, according to the company).

After the proceedings began, however, I realized why I could not take a front seat. Those seated in the first three rows were all men picked by management—employee shareholders and delegates from subcontractors. Those "bodyguards" and "mercenaries" had cornered the seats early in the morning, long before ordinary shareholders arrived.

Every time the chair of the meeting, Kojima Masashi, then NTT president, put forth an item from the agenda, someone in the front rows shouted, "*Igi nashi*" (no objection) or "*Sansei*" (aye). About a dozen people, including a few men in gaudy suits—possibly sôkaiya—as well as bona fide shareholders attending for the first time, asked several questions. Among them were these:

Why is the company making less profit than before? What are you going to do about the counterfeit telephone cards? Will the company plow back the profits from listing its subsidiaries?

The question-and-answer session proceeded smoothly in a businesslike manner. There was little booing and heckling. In due course, the chairman called an end

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to questions and answers, although there was a man at the microphone waiting for his turn to ask a question. "We now proceed to voting," declared the chairman, and then one item after another was voted on in rapid succession amid shouts of "Igi nashi" from the planted shareholders. The meeting ended before noon. I came away with a sense of emptiness, wondering whether an annual meeting like this was really worth holding.

Most Japanese companies close their books at the end of March and hold their annual meetings on the same date in late June. The reason is simple. With so many companies meeting in the same period of the same day, it is physically impossible for a sôkaiya to attend more than one session on the same day.

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According to a 1996 survey by the National Police Agency, 1,382 of the companies listed on the Tokyo Stock Exchange—about 80 percent—held their annual shareholder meetings on June 27. Setting the pace each year, it is said, are companies that hold the leadership position in their respective industries—NTT, Tokyo Electric Power Co. and the presiding bank of the Federation of Bankers Associations of Japan—to name just a few. Other companies follow suit, setting their respective meetings for the same date fixed by their industry leaders. This shows how desperate companies are to keep sôkaiya at bay. Another strategy is to make the duration of the meeting as short as possible and thus give them little time, if any, to disrupt the proceedings. Statistics show that 31.5 percent of the annual shareholder meetings held in 1996 lasted between 20 and 25 minutes, and 30.3 percent between 15 and 20 minutes.

It is easy to understand why management, anxious to hold a peaceful meeting, tries to keep the proceedings at a shareholder meeting to the bare minimum, clearing the agenda quickly according to script. Such staged meetings are often described sarcastically as *shan shan sôkai* (hand-clapping general meeting). Whether this ingrained corporate habit will change remains to be seen.

It is widely believed, both in Japan and abroad, that Japanese companies make light of the shareholder's rights. However, the legal status of the shareholder is not as low as it may seem. In the United States, generally the only thing that requires approval by a regular shareholder meeting is the election of directors. In Japan, by contrast, approval is required for a variety of items, including the election of directors and statutory auditors, executive compensation, balance sheets, profit and loss statements and appropriation of retained earnings. Strictly speaking, companies cannot pay taxes and dividends—they cannot even conduct routine business activities—unless these and other required items are approved by shareholders in the annual meeting. In reality, however, there is a wide gap between what Japanese shareholders are legally entitled to do and what they are actually permitted to do.

Cross-shareholding between companies, a salient feature of Japan's corporate culture, is a major factor behind the weakness of individual shareholders. Majority interest in a company is normally held by big corporate shareholders that support the management—banks, clients, members of *keiretsu* business groups. During the high-growth period, main banks supplied working capital to their member industrial corporations. Naturally, those companies were concerned far more about the wishes of their banks than those of their individual shareholders.

Corporate governance, or the way a company conducts itself, also has much to

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do with the sterile atmosphere of annual meetings. Most directors are executives who have climbed the promotion ladder within their respective companies, much as top civil servants who have risen through the ranks of bureaucracy. Indeed, many companies maintain a rigid bureaucratic hierarchy, so that employees aspiring to the directorship tend to play safe, deftly avoiding mistakes that could destroy their chances of success. The president or the chairman has such great powers, including selection of directors and auditors, that he effectively controls the company. It is in this kind of corporate society that postwar sôkaiya have carved out a lucrative niche.

Ensuring a Peaceful Meeting

Management, while paying little attention to small, individual shareholders, nevertheless knows that they are entitled by law to a range of rights. The fact is, individual shareholders are not powerful enough to overrule management decisions because they are in the minority; corporate shareholders hold controlling interest through cross-shareholding. Still, management traditionally favors a short, quiet annual meeting. For one thing, company chief executives who preside over the meetings are not accustomed to taking hard-hitting questions from angry shareholders, much less booing and heckling. So they try to make sure meetings are conducted according to script. Subordinates in charge, such as general affairs managers, often pay off sôkaiya who even threaten filibusters by taking advantage of shareholder rights.

In a private comment on the Ajinomoto scandal, a young chief executive warned himself: "A president should never say to his subordinates, 'I hope you will handle the meeting well.'" He hits the nail right on the head. Indeed, it is impossible to sever ties with sôkaiya unless top executives take a strong stance against them, instead of paying lip service to the law.

The existence of sôkaiya had been taken for granted until the Commercial Law was amended. It was not uncommon, sources say, that companies gave them money regularly on fixed dates. Business reporters on the beat used to tell this joke about a journalist colleague who was mistaken for a sôkaiya. When the reporter visited a company office soon after 9 A.M., a receptionist told him to go upstairs to join a group of people waiting in line. He did as he was told, and shortly afterward he was handed an envelope containing several thousand yen.

Early in the postwar period there was a clear distinction between sôkaiya and gangsters. The line blurred as sôkaiya became agents of violence in extorting protection money from companies and as *yakuza* moved in for a piece of the action. Beginning around the 1970s, police arrested many sôkaiya for using violence at annual meetings. This led to tighter crackdowns not only on those who received payoffs but also on companies that made such payments. When the law was toughened in 1982, the changes hit sôkaiya particularly hard. Previously they had received payments in various forms, such as subscription fees for their magazines, charges for corporate ads in periodicals of dubious value and rewards for "advisory services." Now most, if not all, of their "clients" tried to cut off ties with sôkaiya once and for all. The beleaguered sôkaiya undertook a counteroffensive with a vengeance.

At Sony Corp.'s annual shareholder meeting held in January 1984, a group of shareholders took turns asking management about the sales and profit setbacks

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for the previous fiscal year and about the market failure of the Beta-format videocassette recorder, created by Sony, against the competing VHS system developed by Victor Corp. of Japan (JVC). The questioners—no doubt sôkaiya and their cousins—were bent upon trying to disrupt the meeting and harass the management. The session lasted more than 13 hours, including lunch and supper and two intermissions. It opened at 10 A.M. on the eighth floor of the company's head office in Tokyo's Shinagawa Ward and ended at 11:30 P.M. When asked for comment afterward, Ôga Norio, then the Sony president and chairman of the meeting, said, "I'm exhausted."

The marathon meeting, it is said, was staged by cash-strapped sôkaiya to demonstrate their clout. Ôga, then relatively young to be a company president in Japan, had both the guts and the stamina to meet the challenge against his patience. To other companies headed by elderly executives, as is more often the case with Japanese businesses, the Sony meeting must have come as a shock.

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During the go-go years of the late 1980s, the period of the so-called bubble economy, sôkaiya seemed to have gained a new lease on life. This is because a great many companies played the money game—buying real estate and trading securities—and becoming mired in the underground economy in the process. Gangsters as well as sôkaiya set up their own companies, making handsome profits supplying a variety of cut-rate goods or acting as subcontractors in high-risk projects. They also did "dirty work" in commercial real estate development, such as assembling small lots of land to sell as one block by harassing the tenants and threatening the landowners. In the process they gained knowledge of the skeletons in the corporate closet—scandals involving real estate deals.

Alarmed by the resurgence of sôkaiya, the Tokyo Metropolitan Police Department appealed to the business community to make a clean break with these underground operators, saying that if companies called it quits, the police would not bother about their past links with sôkaiya. The recent flurry of sôkaiya scandals, however, indicates the police appeal had little effect. Utada Katsuhiro, former Ajinomoto president, has been spreading the gospel of corporate disclosure as chairman of the Japan Investor Relations Association. Yet he was unable to prevent his own company from getting involved with sôkaiya. Nomura has been doing much the same thing through an affiliate that provides advisory services on disclosure of corporate information.

Police estimate there are about 1,000 sôkaiya operating in Japan. But just as being a member of an organized crime syndicate is not in itself a crime, sôkaiya cannot be arrested without proof they have received payoffs that violate the Commercial Law.

Although executives at prestigious companies know it is wrong and is a serious violation of the rules of the market to deal with sôkaiya, they have done just that for a long time. What emerges from all this is the fact that many companies simply do not have the courage to ostracize these corporate goons. But it is also true that more executives are being moved to action to stamp out this corrupt practice.

Square, a major producer of software for video games, held its annual meeting on Sunday, June 23, 1996, in Tokyo's Shinjuku, so shareholders could bring their children along. At the meeting, the company set up a section in the meeting hall to demonstrate soon-to-be-released video game programs. Children of shareholders tried the new games at what looked like a mini game arcade while their

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parents were in the meeting.

Square takes the novel approach of holding its annual meetings in a casual atmosphere with "open-house" programs for the family, believing that trouble-making professional shareholders will stay away.

Gourmet Kineya Co., an Osaka-based chain of family restaurants, held its shareholder meeting in Tokyo in December 1996, departing from company bylaws that specify the meeting should be held in Osaka. The president, Mukumoto Hikoyuki, said he had selected the capital so that he could meet more shareholders face to face. Mukumoto himself had a disappointing experience when he attended an annual meeting of a chemical company about 30 years ago. As a shareholder in the company, he wanted to speak directly to its top executives. But he had no opportunity to do so because the meeting was concluded in just 30 minutes, with everything scripted in advance. The experience, he said, led him to ensure that his own company's meetings were dialogue-oriented.

The December meeting was followed by a reception in a separate room where shareholders and executives could mix and talk freely while enjoying some of Kineya's foods. Mukumoto recalls he received valuable ideas and suggestions from shareholders about management strategy and expanding the restaurant outlets. And he said he does not understand why so many companies seek out sôkaiya to help keep a semblance of order.

Toyota Motor Co., whose chairman, Toyoda Shôichirô, heads Keidanren, the Federation of Economic Organizations, holds its sôkai on a different day from most other companies. With Keidanren—Japan's most influential business group—urging its member corporations to operate as transparently as possible, Toyota, as the organization's presiding company, has compelling reasons to set an example by breaking away from the same-day strategy.

It is also worth noting that the Supreme Court, in a November 1996 ruling, determined that it is not appropriate for employee shareholders to take front-row seats in advance of the meeting. The decision is bound to affect traditional efforts to fend off sôkaiya influence.

Pressure to Avoid Resorting to Payoffs

Thus the corporate attitude toward sôkaiya is changing, though slowly. Companies will undoubtedly be under growing pressure to improve the way they conduct their annual meetings and to make them more meaningful and substantive. There is a growing sense abroad that buying the influence of sôkaiya, for whatever domestic reason, must not be condoned.

The few weeks before the annual meeting season are always a busy period for foreign institutional investors who hold equity stakes in Japanese companies. They are informed in writing, two weeks ahead of the meetings, about the agenda items to be put to a vote. Fund managers must check every item and decide how to vote and tell management their decisions.

Overseas investors are critical of companies that pay out too little, or too much, of their profits in shareholder dividends. They believe, rightly, that a company that pays dividends that disregard its losses will hurt its own business interests, if not immediately then certainly in the long run. Foreign investors are also against drastic increases in equity capital, such as doubling it at one time. They fear that such actions weaken the voice of existing shareholders.

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Most foreign institutional shareholders have only marginal holdings, usually not more than 1 percent of outstanding shares, and thus have little real influence on the voting outcome of questions that come before an annual meeting. But such investors, especially those from the United States, keep a sharp eye on management. In the past, U.S. investors were concerned almost entirely about domestic corporations. They showed little interest in non-U.S. corporations, partly because of the language barrier and the onus of working around the clock across different time zones, but mainly because they held small stakes. So they gave carte blanche to management. In recent years, however, things began to change significantly. A case in point is an official letter sent by the U.S. Department of Labor in March 1994 to Howard Sherman, senior executive vice president of Institutional Shareholder Services, and others in similar positions. The letter not only confirmed the basic principle that pension fund managers have an obligation to exercise voting rights on behalf of beneficiaries, or contributors, but also made clear that the obligation extends outside the United States as well. The principle behind such responsibility was established in the Interpretive Bulletin that the department issued in 1988 concerning the Employee Retirement Income Security Act of 1974, known as ERISA.

Although the document mentions the need to weigh extra costs, such as translation expenses, against the benefits to be gained by attending annual meetings abroad, there is no mistaking the underlying message: It does not stand to reason, given the interests of contributors, that U.S. pension funds should give carte blanche to the management of Japanese companies in which they hold significant blocks of stock.

In July 1994, the Pension and Welfare Benefits Administration of the Department of Labor issued a statement reaffirming the content of the letter. The Interpretive Bulletin has served effectively as a set of guidelines for private and local-government pension funds as well as investment trusts. Thus the letter is expected to have a considerable effect on Japanese companies as well. Now U.S. institutional investors are beginning to take a more critical look at Japanese companies. It is certain that pressures for transparency and fairness—for open shareholder meetings and for greater attention to the rights of individual shareholders—will gain momentum.

Japanese companies stand at a crossroads. If they continue to allow the rampage of sôkaiya, a symbol of nontransparency in Japan's corporate system, foreign distrust in corporate Japan will never go away. As a result, the Tokyo stock market could remain locked in a slump. The Nikkei index of 225 selected stocks has been hovering in the ¥20,000 range, about half its peak of ¥38,915.87, posted in late December 1989. One essential condition for a market revival is active participation by international institutional investors with long-term strategies. The question for Japanese companies is whether they will be able to cut their ties to sôkaiya and build a management system that is truly oriented toward shareholder interests. If they fail in this effort, they will never be able to win in a competition that is played by the rules of the global market.

The challenge for Japan's corporate executives is clear enough: Change the way annual meetings are held and eliminate collusion with sôkaiya. Unless and until this is done, the peculiar custom of holding their annual meetings all on the same day will remain a permanent feature of Japan's corporate culture.

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