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Increasing the Competitiveness of U.S. Corporations: Is Bank Monitoring the Answer?

Corinne A. Franzen

It is widely believed that managers of corporations in the United States generally pursue short-term growth strategies.¹ What is less understood are the forces that constrain these corporate managers and shape their decisions. The predominant reason cited for the perceived "short-sighted" approach of many U.S. corporations is that investors in the United States demand continuous improvement in short-term earnings. U.S. investors require short-term earnings because stock ownership is inherently risky, and U.S. investors have little or no access to corporate information which might mitigate that risk.² One result is that U.S. corporations have a high equity cost of capital which impacts their long-term strategies by making investment in research and development more expensive.³ Thus, the result of the high equity cost of capital in the United States is that U.S. corporations lack sufficient access to the long-term capital necessary to finance new plants and equipment and to support research and inventories which will lead to increased long-term

¹. A recent international survey ranked business firms of twenty-three nations on their ability "to take the long view." Lester Thurow, Let's Learn from the Japanese, FORTUNE, Nov. 18, 1991, at 183. The survey ranked U.S. firms twenty-second, ahead only of Hungarian firms. Id.

². See infra text accompanying notes 145-51.

³. Corporations often use net present value analysis in determining whether to pursue a project. Net present value (NPV) is defined as the discounted value of all cash inflows less the discounted value of all cash outflows. The value of future cash inflows diminishes as the discount rate (expectations of risk and inflation) rises. If the NPV is positive, the corporation can conclude that the rate of return on the project is greater than the corporation's cost of capital. Investment in research and development is often a long-term project, demanding large cash outflows in the short term and providing cash inflows only over the long-term. Especially when interest rates are high, cash outflows are likely to exceed inflows; therefore, a corporation's decision to invest in research and development is a difficult one, because a high discount rate means that the investment has to result in enormous future cash inflows to make the investment worthwhile. See generally WILLIAM A. KLEIN & JOHN C. COFFEE, JR., BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES 280-297 (4th ed. 1990).
Corporations in other countries, particularly Japan and Germany, do not face the same deficiency in long-term capital, to a large extent because those countries allow banks to own stock in and to monitor corporations. The banks, as corporate "insiders," have access to information about the corporation and its long-range plans, which decreases their risk of investment. Moreover, the banks, particularly in their role as lenders, prefer a strategy which emphasizes the continued vitality of the company. Thus, it is cost effective and profitable for banks to closely monitor the actions of the corporation. The result is that the major investors in Japan and Germany do not demand continuous improvement in short-term earnings, and corporations are able to make the long-term decisions needed to maintain or increase competitiveness in the international marketplace.

In the United States the Glass-Steagall Act tightly restricts bank ownership of corporations, and U.S. banks, unlike their German and Japanese counterparts, are prohibited from dominating corporate boards. This difference is significant because bank ownership and monitoring of corporations appears to decrease the cost of capital, allowing corporate managers to adopt a long-term view, which results in increased international competitiveness.

This Note examines whether the United States could increase the long-term competitiveness of U.S. firms in the international marketplace by modifying the Glass-Steagall Act's current prohibition on bank control, thereby alleviating the pressure caused by short-term measures of performance. Part I examines corporate governance as it currently exists in the United States, and compares it with corporate governance in Ja-

5. See generally discussion infra text accompanying notes 105-29.
7. Id.
8. This Note will not address other significant issues of corporate governance, including shareholders rights and the duties the board has toward its shareholders.
U.S. CORPORATE COMPETITIVENESS

pan and Germany. This comparison specifically focuses on the means by which corporate management is monitored in each of the countries and the role that banks play in that process. Part II examines the hypothesis and causes of "short-termism" in the United States, discusses how bank monitoring in Japan and Germany reduces pressures on managers to pursue short-term strategies, and considers the impact which proposed banking reforms may have on corporate monitoring in the United States. Part III concludes that a modification of the Glass-Steagall Act, which would permit banks to own stock in and to monitor corporations in the United States, would decrease the equity cost of capital for investment. The decrease in equity cost, in turn, would allow for expanded research and development and result in increased long-term international competitiveness.

I. CORPORATE GOVERNANCE: A COMPARATIVE VIEW

An examination of the socio-political context of corporate and general business practices in the United States, Japan and Germany provides a basis for understanding the role of corporate monitoring in each country. The following discussion concentrates on the identity and effectiveness of the corporate monitors in each country and demonstrates that banks in Japan and Germany are able to monitor and control corporations to a much greater extent than the fragmented individual and institutional shareholders in the United States.

A. UNITED STATES

Corporate management in the United States is monitored by diverse shareholders and market forces. Neither has proven capable of providing an incentive for corporate management to forego short-term profits in return for market share and long-term growth. Dispersed shareholders in the United States provide the capital needs of large publicly-held companies, necessarily separating ownership from control of these companies. Individual shareholders rarely hold large blocks of stock, and


10. "Corporate monitor" or "monitor" will be used throughout this Article to describe the individual shareholders and/or institutional investors which take an active interest in the affairs or management of a corporation.

the capacity of each stockholder to exert control over corporate actions becomes more limited as the number of stockholders increases. Thus, corporate wealth is held by most shareholders as a "passive investment," allowing managers to control the day-to-day affairs of the corporation and make fundamental decisions without any intervention or significant pressure from the true owners of the corporation. The normal outlet for shareholders to express their displeasure with corporate decision-making is to sell their interest rather than take an active interest in the management of a company, or to institute actions to influence or replace management. Thus, corporate managers in the United States are not directly monitored and controlled by shareholders; rather, they are controlled by the market and by the threat of takeover in the event they are not maximizing asset potential.

1. The Glass-Steagall Act

The U.S. system of separate ownership and control over corporations is the result of laws passed in response to the Great Depression of the 1930s. Prior to the 1930s, the United States had bank-centered business groups very similar to those now found in Germany and Japan. U.S. bankers typically held seats on their customers' boards, owned their stock, and fre-


13. Roe, supra note 11, at 12.

14. James E. Heard, Institutional Investors and Corporate Governance: The U.S. Perspective, in INTERNATIONAL CORPORATE GOVERNANCE 245, 251 (Joseph C.F. Lufkin & David Gallagher eds., 1990). Investors can protect their interests at less expense by selling their shares in enterprises that are inefficiently managed and switching their resources to better-managed companies. This principle of investor behavior has been called the "Wall Street Rule." Id. The problem underlying the Wall Street Rule is that individuals who take an active interest in the affairs or management of a company are giving a "free ride" to the rest of the shareholders, who own the remaining stock. LOWENSTEIN, supra note 4, at 252. See also Alfred F. Conard, Beyond Managerialism: Investor Capitalism?, 22 U. MICH. J.L. REF. 117, 144-45 (1988). Conard argues that although the Wall Street Rule fits a typical individual investor, it may not be a pervasive principle of conduct among institutional investors. Id. at 145. For a discussion of the expanding role of institutional investors, see infra note 34.

15. Masahiko Aoki, Toward an Economic Model of the Japanese Firm, J. ECON. LITERATURE, Mar. 1990, at 1, 16. For a discussion of takeovers, see infra text accompanying notes 130-44.

16. For example, the House of Morgan was a group that included U.S. Steel, International Harvester, General Electric, and 37 other American firms. LESTER C. THUROW, HEAD TO HEAD, 135-36 (1992).
quently consulted with senior management about long-term strategies and short-term operating plans. U.S. banking and securities laws during this time, however, were permissive and banks, due to their enormous influence, were able to manipulate certain companies. Congress attributed the failure of a large number of banks during the Depression to these activities, and reacted by passing the Glass-Steagall Act. This act banned banks from underwriting corporate securities or owning equity in nonfinancial companies. The Glass-Steagall Act was Congress' response to charges against some banks of conflict of interest and fraud, and the fear of banks taking similar risks with depositor money after the stock market collapse and during the Great Depression. Section 16 prevents a bank from underwriting, distributing, selling, or dealing in investment securities, except on its own account. Section 20 bars banks from affiliating with any company engaged principally in underwriting securities. Section 21 makes it unlawful for investment banks to ac-

17. JACOBS, supra note 9, at 143.
18. Id. at 144. Examples of such manipulation include: bankers loaning money to customers to purchase equities sold by the bank's own securities departments, often at inflated prices; banks purchasing overvalued stocks from their securities affiliates to place in customers' trust accounts; and banks raising money for their customers by selling whose proceeds were used to pay off outstanding bank loans before a company failed. Id.
21. Id.
22. 138 CONG. REC. E2877-02, E2878 (1992). The Banking Act was passed "[t]o provide for the safer and more effective use of the assets of banks, . . . to prevent undue diversion of funds into speculative operations, and for other purposes." Banking Act of 1933, ch. 89, 48 Stat., at 162. See also Tavelman, supra note 19, at 1511.
23. Section 16 provides in pertinent part:

The business of dealing in securities and stock by the association shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account, and the association shall not underwrite any issue of securities or stock; Provided, that the association may purchase for its own account investment securities under such limitations and restrictions as the Comptroller of the Currency may by regulation prescribe.

24. Section 20 states in pertinent part: "[N]o member bank shall be affiliated in any manner . . . with any corporation, association, business trust, or other similar organization engaged principally in the issue, flotation, underwrit-
cept deposits, and section 32 prohibits any officer or director of a commercial bank from managing a company engaged primarily in the securities business. Some banks attempted to circumvent these restrictions by forming holding companies; but Congress enacted the Bank Holding Company Act in 1956, which prohibited bank-owned companies from engaging in "non-banking" activities. Congress also passed laws limiting pension funds and mutual funds to the ownership of only ten percent of the stock of any one company.

The passage of the Glass-Steagall Act, however, has not created an impenetrable barrier between commercial and investment banks. First, not all banks are affected by the act. State-chartered banks which are not members of the Federal Reserve System are not subject to the prohibitions of the act, and Glass-Steagall does not apply to the overseas activities of U.S. banks. Second, banks are not completely prohibited from engaging in investment activities. Banks can buy or sell securities on behalf of customers as long as they do so without providing investment advice, and are able to underwrite debt instruments of the federal government and general obligation mutual bonds. Even more significantly, bank affiliates can engage in otherwise pro-

25. Section 21 provides in pertinent part, that it is unlawful [(f)or any person, firm, corporation, association, business trust, or other similar organization, engaged in the business of issuing, underwriting, selling, or distributing, at wholesale or retail, or through syndicate participation, stocks, bonds, debentures, notes or other securities, to engage at the same time to any extent whatever in the business of receiving deposits subject to check or to repayment upon presentation of a passbook, certificate of deposit, or other evidence of debt, or upon request of the depositor . . . .


29. See infra note 35. See also THUROW, supra note 16, at 135-36.


31. Id.
hibited activities so long as they are not "principally engaged" in them. However, even though Glass-Steagall has not created an impenetrable barrier between commercial and investment banks, no interpretation of Glass-Steagall allows U.S. banks to own significant amounts of stock in corporations.

2. Institutional Investors

Institutional investors own a significant percentage of stock in U.S. corporations; however, the potential for effective

32. Section 20 of the Glass-Steagall Act, 48 Stat. 184, at 188 (codified as amended at 12 U.S.C. § 377 (1988)), prohibits national banks or state member banks of the Federal Reserve System from owning securities affiliates, defined in § 2(b), 48 Stat. 162, that are "engaged principally" in the issuance or underwriting of securities. See supra note 24. On several occasions the courts have reviewed the Board of Governors interpretation of "engaged principally." In Board of Governors of Federal Reserve System v. Investment Co. Institute, 450 U.S. 46 (1981), the Supreme Court upheld the Board of Governors decision to permit bank holding companies to act as investment advisers for closed-end investment companies. This decision was based on the court's understanding that "[i]nvestment advisers and closed-end investment companies are not 'principally engaged' in the issuance or the underwriting of securities within the meaning of the Glass-Steagall Act ...." Id. at 71. In Securities Industry Ass'n v. Board of Governors of Federal Reserve System, 847 F.2d 890 (D.C. Cir., 1988), the court upheld the Board's interpretation of "engaged principally" in § 20 as precluding bank ownership of affiliates whose securities business is substantial, measured by revenue and market share limits. Affiliates whose underwriting or dealing in securities is a regular or integral part of the affiliates' business, but is not substantial, are not precluded by the Act. Id. In Securities Industry Ass'n v. Board of Governors of Federal Reserve System, 716 F.2d 92, (2nd Cir., 1983), aff'd, 468 U.S. 207 (1984), the court held that a bank holding company may acquire a brokerage firm because a brokerage business does not constitute a "public sale" of securities under § 20, thus the bank holding company would not be "engaged principally" in the public sale of securities.

Section 32 of the Glass-Steagall Act prohibits directors, officers, or employees of banks from simultaneously holding similar positions at firms "primarily engaged in the issue, flotation, underwriting, public sale or distribution .... [of] securities ...." 12 U.S.C. § 78 (1982) (emphasis added). In Board of Governors of Federal Reserve System v. Agnew, 329 U.S. 441 (1947), the Supreme Court held that an activity or function is "primary" if it is a substantial activity or function of the firm. "An activity or function may be "primary" in that sense if it is substantial. If the underwriting business of a firm is substantial, the firm is engaged in the underwriting business in a primary way, though by any quantitative test underwriting may not be its chief or principal activity." 329 U.S. at 446.

33. Institutional investors include pension funds (both private and public), investment companies, insurance companies, bank non-pension trusts, and foundations and endowments. See A. A. Sommer, Jr., Corporate Governance in the Nineties: Managers vs. Institutions, 59 U. Cin. L. Rev. 357, 362 (1990).

34. "In 1980, institutions held 33 percent of all publicly quoted American shares. [In 1991], .... they are believed to own 45 percent." Roberta S. Karmel, Is It Time for a Federal Corporation Law?, 57 BROOK. L. REV. 55, 68 (1991). See also Richard M. Buxbaum, Institutional Owners and Corporate Managers: A
corporate monitoring by institutional investors in the United States is limited by tight restrictions on their ability to own a significant percentage of stock in any one corporation. Banks, as noted above, are prohibited from directly owning and under-

Comparative Perspective, 57 BROOK. L. REV. 1, 16 (1991). Moreover, institutional assets are heavily concentrated. "In 1989, institutions held 50 percent of the stock in the top fifty public corporations, 55.5 percent in the top 51-100, and 54.2 percent in the top 101-250." Karmel, supra, at 68. Among the institutions, pension funds are the largest holders. Sommer, supra note 33, at 361. "By the end of 1989, pension funds owned an estimated 25-40 percent of publicly traded equities and they could own 50 percent by the year 2000." Karmel, supra, at 68. See also John H. Matheson & Brent A. Olson, Corporate Law and the Longterm Shareholder Model of Corporate Governance, 76 MINN. L. REV. 1313, 1355 (1992). "At the end of 1988, the top thirty public and private pension funds held approximately 27.3 percent of the asset value of all such funds and 39.6 percent of the assets of the thousand largest funds." Karmel, supra at 68.

35. Stock ownership by mutual funds is restricted by the Investment Company Act of 1940 which provides that a mutual fund cannot advertise itself as diversified if the regulated part of its portfolio owns more than 10% of the stock of any company, even if that stock is a small portion of the fund's portfolio. Investment Company Act of 1940, § 5(b), 15 U.S.C. § 80a-5(b) (1988) [hereinafter 1940 Act]. The "regulated" part of the portfolio is three-quarters of the portfolio, only one-quarter is unregulated. Id. The 1940 Act also prohibits a "diversified" mutual fund from placing more than 5% of its regulated assets in the securities of any one issuer. 1940 Act, supra, § 5(b)(1), 15 U.S.C. § 80a-5(b)(1) (1988). Mutual funds are encouraged to be "diversified" by considerable tax penalties for non-diversified funds. See Roe, supra note 11, at 19-20. Mutual fund assets in 1993 stand at $1.6 trillion, compared with less than $50 billion in 1977. Jeffrey M. Laderman & Geoffrey Smith, The Power of Mutual Funds, Bus. Wk., Jan. 18, 1993, at 62.

Stock ownership by insurance companies is restricted by the laws of the state in which the policy is sold. See Roe, supra note 11, at 23. In New York, 20% of a life insurer's assets, or one-half of its surplus, can go into stock. N.Y. Ins. Law § 1405(a)(6), (8). See Roe, supra note 11, at 22. However, an insurance company cannot take influential blocks because New York laws limit insurance companies to placing 2% of their assets into the stock of any single issuer, and property and casualty insurers cannot control a non-insurance company. Id. at 22-23. Other states have similar rules. Id.

Pension funds are the least regulated institutional investor. Id. at 23. However, stock ownership by pension funds is restricted by their limited assets and fragmentation. Id.

[E]ach company typically sets up its own fund, often giving money to several managers, who receive money from several companies. Since ERISA (the Employee Retirement Income Security Act of 1974) generally requires each fund to be diversified, there is little room for an influential position in an operating company. ERISA allows deviation from diversification only if 'clearly prudent' not [to minimize] the risk of large losses.'

Id. at 24 (quoting ERISA § 104(1)(C), 29 U.S.C. § 1104(1)(c) (1988)). Moreover, pension managers are hired and controlled by a plan sponsor's management, and risk angering their own company's senior management if they take an active role. Id. at 24.
writing any common stock by the Glass-Steagall Act of 1933.36 The Bank Holding Company Act prevents bank holding companies from owning more than five percent of the voting stock of any operating nonbanking company, unless the additional stock is nonvoting.37 Bank trust departments are not restricted in stock ownership and may invest up to ten percent of their funds in the stock of a single corporation.38 Thus, although national banks may not directly own equity securities for their own benefit, bank holding companies, bank trust companies, and other institutional investors may own equity securities for their own benefit, to a limited extent.39

B. JAPAN

Corporate management in Japan is monitored by banks and voluntary groupings of corporations which effectively monitor


(i) banks generally do in fact conduct the proposed activity; (ii) banks generally provide services that are so operationally or functionally similar to the proposed activity that they are particularly well-equipped to provide them; or (iii) banks generally provide services that are so integrally related to the proposed service as to require their provision in a specialized form.

Deborah S. Prutzman, Selected Issues Relating to Securities Activities of Banking Institutions, in Banking Law Series, at 179, 183-84 (PLI Commercial Law & Practice Course Handbook Series No. 600, 1992). In effect, essentially any major bank may legally acquire up to 5% of the voting stock of an industrial corporation through a parent or securities affiliate. Coffee, supra, at 1313 n.153.


39. Coffee, supra note 37, at 1315 n.156. However, one author has argued that even if bank holding companies and bank trust companies were able to purchase a large stake, the prohibition on direct bank control limits what the bank can do with a large stake, and thus reduces incentives to acquire such a stake. See Black, supra note 37, at 552.
and encourage each other to pursue a long-term focus. Banks in Japan face regulations similar to those found in the United States. For example, under Section 65 of Japan's Securities and Exchange Act of 1948, a Japanese bank may not engage in investment banking. Under section 11 of Japan's Anti-Monopoly Act, a Japanese bank may not own more than five percent of the stock of any domestic corporation. In practice, however, these restrictions have been unsuccessful due to the formation of voluntary economic coalitions of firms and financial institutions known as *keiretsu*. Japanese culture emphasizes the group, rather than the individual, as the key social entity. This emphasis is one explanation for the ability of *keiretsu* to exert control over corporations in Japan.

Until 1945, much of Japan's economy was controlled by large family-owned, bank-centered conglomerates of interrelated industrial, financial, and commercial enterprises known as

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40. THUROW, supra note 16, at 134.


43. *Shiteki dokusen no kinshi oyobi kosei torihiki no kakufu ni kansuru horitsu* (An act regarding the prohibition of private monopolies and the maintenance of fair trade), § 11(a), Law No. 54 of 1947, cited in Coffee, supra note 37, at 1294 n. 61.


46. PRESTOWITZ, supra note 45, at 82. Groups define a person's existence in Japan; conformity, group ethics, and *ningen kankei* (close human ties) are stressed as worthwhile virtues. Id. at 82-86.

47. Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187, 219 (1991). The six major *keiretsu* in Japan, see supra note 45, account for roughly 17% of the sales of all Japanese business and roughly 18% of the profits, excluding the results of banking and insurance. PRESTOWITZ, supra note 45, at 157. Each group contains companies in each major area of the Japanese economy. Id.
zaibatsu. The U.S. Occupation forces in Japan broke up the zaibatsu; but, after the end of the Occupation, they were reassembled into the keiretsu, a looser regrouping of the former zaibatsu interests. While the zaibatsu were directly controlled through family holding companies, the keiretsu are based around core banks and trading companies. Each keiretsu typically consists of an association of companies and a "main bank" which serves as their chief source of financing. The main bank in a keiretsu is usually both a significant shareholder and the principal creditor of the keiretsu members, and is responsible for closely monitoring their business affairs. Unlike individual investors in the United States, it is cost-effective and profitable for the bank to closely monitor the corporation because the bank is both a shareholder and has a large loan share. In the normal course of events, the bank does not exert control in corporate policymaking or the selection of management; however, in a business crisis, the bank assumes major responsibility for rescue operations. The keiretsu enable companies to share risk and provide a mechanism for allocating investment.

48. Id. at 156-57. The four largest zaibatsu were Mitsui, Mitsubishi, Sumitomo, and Yasuda. Id.
49. Id. at 157. See also Coffee, supra note 37, at 1295.
50. PRESTOWITZ, supra note 45, at 157.
52. A recent study reports that, on average, a Japanese company's largest debtholder owned 6.2% of the company's equity; that the five largest debtholders owned 18.2% of the equity; and that out of 133 companies surveyed, the largest debtholder was the largest shareholder in 57 cases or was a member of the same keiretsu as the largest shareholder in an additional 67 cases. Coffee, supra note 37, at 1295 n.66.
53. Id.
54. Aoki, supra note 15, at 14. Businesses maintain long-term ties with the banks, often make deposits when the banks need them, sell bonds through the banks, and often purchase the bank's shares to establish solid cross-shareholding relationships. System at Crossroads, supra note 51, at 1341. This close relationship has been blamed for a series of banking scandals over the past two years. Id.
55. Rescue operations may include the rescheduling of loan payments and emergency loans. Aoki, supra note 15, at 14. For example, Sumitomo Bank, Ltd. in early 1991 rescued Itoman & Co., a significant Japanese trading firm with massive property-related debts. Sumitomo ejected Itoman's top executive and arranged to transfer most of Itoman's property-related debts to other parties, including itself, better positioned to handle them. JACOBS, supra note 9, at 155-56.
56. See infra notes 59-69 and accompanying text.
57. Ferguson, supra note 44, at 58.
also combine monitoring and control functions in one actor: the main bank.\textsuperscript{58}

The \textit{keiretsu} structure in Japan is maintained through a system of "cross-ownership" of stock.\textsuperscript{59} Each company within the group generally owns from 0.5 to three percent of the stock of the other members' firms.\textsuperscript{60} In the aggregate, the constituent companies own a controlling stake in the other members' firms,\textsuperscript{61} locking control within the group. The expectation of assured long-term business relationships\textsuperscript{62} is strengthened by the practice of using other companies in the same \textit{keiretsu} as preferred suppliers.\textsuperscript{63} \textit{Keiretsu} members tend to be more interested

\textsuperscript{58} Paul Sheard, \textit{The Main Bank System and Corporate Monitoring and Control in Japan}, 11 \textit{J. Econ. Behav. and Org.} 399, 400 (1989) (The author notes that his analysis is only partial in that it deals with the relationship between large incorporated companies and financial institutions, and it cannot be assumed that the same economic processes are necessarily at work in the small and medium-sized firm sectors of the economy. Nor should it be overlooked that the main bank system has been subject to pressures for change in recent years as a result of deregulation and internationalization of the financial system and structural changes in the economy).

\textsuperscript{59} Coffee, supra note 37, at 1295-96.

\textsuperscript{60} Id. Approximately 65 to 75\% of the stock in all listed companies on the Tokyo Stock Exchange is held in cross-ownership. \textit{Id.} at 1296.

\textsuperscript{61} Id.

\textsuperscript{62} Lipton, supra note 47, at 219. \textit{See also} Aron Viner, \textit{Mergers, Acquisitions and Corporate Governance in Japan}, in \textit{International Corporate Governance}, supra note 14, at 27, 28. ("The tightly woven web of shareholders helps management give primary attention to long-term plans and decision making, instead of pursuing short-term profits to satisfy the fleeting inclinations of institutional investors.").

\textsuperscript{63} John C. Coffee, \textit{Comparative Corporate Governance}, N.Y. L.J., Mar. 26, 1992, at 5 [hereinafter \textit{Comparative Corporate Governance}]. Rather than taking bids, Japanese firms have one or two suppliers, which have target pricing. \textit{Experts Urge Enforcement}, supra note 45, at 1663.

Japan's paper industry provides an example of the \textit{keiretsu} system. A study commissioned by the American Paper Institute (API) found that Japan's major paper producers hold "significant" equity shares in the major Japanese distributors, and have close ties to printers and other end users. \textit{Trade Policy: Baucus Introduces Bill to Extend Super 301 Provision of 1988 Trade Act}, 8 Int'l Trade Rep. (BNA) 1525 (Oct. 23, 1991). Some major paper producers belong to the same \textit{keiretsu}, and some distributors obtain credit from their paper suppliers. \textit{Id.} The study found that there appeared to be close equity and lending relationships between banks and paper suppliers and distributors. \textit{Id.} Dana Mead, representing API, testified that "[e]mpirical evidence demonstrates that a distributor will often source paper from suppliers with whom it shares a principal bank." \textit{Id.}

The Japan Fair Trade Commission addressed the antitrust implications of these practices when it said that "while the existence of \textit{keiretsu} does not necessarily violate antitrust laws, their way of doing business sometimes keeps foreign competitors out of the Japanese market." \textit{Japan: Government Agency Lists Unfair Practices, Tries to Implement New Antitrust Measures}, 7 Int'l
in the continued strength of the group than in their own short-
term profits because the members gain by receiving and pro-
viding preferential treatment to each other as preferred sup-
pliers and customers, not by being paid dividends. Because the
goal of the group is not to maximize share prices but to expand
market share in each of the various industries represented,
member companies pressure each other to grow and coordinate
their planning. The mutual ownership interest leads keiretsu
members to ratify each other's management decisions when
challenged by outsiders, and rarely to take action which threat-
ens any group member.

Approximately two-thirds of stocks listed on exchanges in
Japan are held by corporations and financial institutions. Often
the majority of shares in a corporation are collectively
owned by members of the same keiretsu. Individual stock-
holders own only about thirty percent of outstanding total equi-
ties of listed companies, and do not have an effective voice in the
.corporate governance structure.

Part of the explanation for the differences between the
American and Japanese systems rests in the reasons for which
they were developed. The American system protects share-
holder rights, and developed in response to the Great Depres-

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64. M. Evan Corcoran, Foreign Investment and Corporate Control in Ja-

65. See supra note 63.

66. THUROW, supra note 16, at 134.

67. Id. at 135.

68. Id.

69. Corcoran, supra note 64, at 347. The process of cross-shareholding

lends stability to a corporation's planning, and reduces risk. PRESTOWITZ, supra

note 45, at 160.

70. Viner, supra note 62, at 27.

71. Lipton, supra note 47, at 219. Major Japanese firms have a quarter of

their stock controlled by large shareholders, compared to only one-twelfth of
the stock of American corporations. Roe, supra note 11, at 59-60. The percent-
age of stocks held by individuals in the United States fell from 71% in 1980 to
49.7% in 1992. Laderman, supra note 35, at 62. Since large shareholders have a
greater incentive to monitor the corporations in which they invest, the implica-
tion is that effective monitoring may occur more frequently in Japan than in
the United States.

In contrast, the Japanese system developed following World War II as an effort by the government to actively encourage the rebuilding of industries. The system of cross-ownership was intended to help keep out foreign investment and imports, and to allow scarce resources to be concentrated in industries which were deemed critical to Japan's long-term economic security. The Japanese system was not designed to protect the small shareholder; rather, it was designed to protect the entire country or community, whose interests take precedence over the short-term interests of individual consumers or stockholders.

C. GERMANY

Corporate management in Germany is monitored by institutional investors (predominantly banks, insurance companies and investment funds), which are the main holders of shares in Germany. Major German banks control corporations through a proxy system by which shares in German corporations are deposited by their owners with the banks. Banks, as intermediaries, can vote the shares on behalf of the owners. This proxy system allows German banks to exercise nearly thirty-

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73. See supra text accompanying notes 16-26.
74. Ferguson, supra note 44, at 58. Ichiro Fujiwara, former vice-minister of the Japanese Ministry of International Trade and Industry (MITI), made the following comments on national strategies:

Let's take the case of the mainframe computer as an example. After the war, Japanese business firms had to start from scratch. To survive, they had to struggle with outmoded technology and meager capital to fend off foreign competitors armed with computerized manufacturing systems and management. No responsible government leaders, faced with such a situation, would have sat on their hands and watched domestic industries crushed under the juggernaut of foreign competition. We had to help the domestic computer industry to get on its feet. Government leaders of other countries had done, and are still doing, the same thing.

75. Ferguson, supra note 44, at 58.
76. Eckhouse, supra note 36, at C1.
78. See Lipton & Rosenblum, supra note 46, at 220. (“Voluntary delegation of voting rights to portfolio-managing banks is the norm among private investors, except for major stockholders.”).
79. Coffee, supra note 37, at 1303-04. See also Lipton & Rosenblum, supra note 46, at 220. The law under which banks exercise the votes attached to the shares for the shareholder is known as the Depotgesetz. Schmalenbach, supra note 77, at 110.
four percent of the total voting power in the top one-hundred German corporations and more than fifty percent of the total voting power in the ten largest companies. In addition, the banks also own shares and often hold seats on corporate supervisory boards, which adds to their power.

Banks, therefore, have tremendous control at general meetings. Often banks may hold more than fifty percent of the voting rights present at a particular shareholder meeting, an amount which is not proportional to the economic share of such banks in the companies concerned. Moreover, bank control is concentrated — three banks control forty percent of the stock in German corporations.

German corporations are even more dependent on banks than their Japanese counterparts for access to all forms of external finance. Unlike banks in Japan and the United States, German banks perform the Hausbank (house bank) function which allows them to handle both commercial banking and se-

80. Coffee, supra note 37, at 1303.

81. Lipton & Rosenblum, supra note 46, at 220. See also Roe, supra note 11, at 60. German banks own under 5% of the stock of the largest one hundred German corporations. See Coffee, supra note 37, at 1303. See also John Cable, Capital Market Information and Industrial Performance: The Role of West German Banks, 95 ECON. J. 118, 120 (1985). However, German banks can lawfully hold up to 25% of the common stock of any non-banking firm. Buxbaum, supra note 34, at 36. Deutsche Bank provides an example of banks holding seats on corporate supervisory boards; its executives sit on over 400 such boards. JACOBS, supra note 9, at 70.

82. Schmalenbach, supra note 77, at 117. See supra notes 78-81 and accompanying text.

83. Lipton & Rosenblum, supra note 46, at 220. See also Schmalenbach, supra note 77, at 110. For example:

[T]he Deutsche Bank directly owns ten percent or more of the shares in seventy companies: twenty-eight percent of Germany's largest company, Daimler-Benz; ten percent of Europe's largest reinsurance company, Munich Rai; twenty-five percent of Europe's largest department-store chain, Karstadt; thirty percent of Germany's largest construction company, Phillip Holzmann; and twenty-one percent of Europe's largest sugar producer, Suzucker . . . [Moreover,] Deutsche Bank executives sit on four hundred corporate boards . . . the large universal banks own ten to twenty-five percent of the shares in forty-eight of the largest one hundred [industrial] firms, twenty to fifty percent of the shares in forty-three others, and over fifty percent of the shares in nine of the one hundred largest [industrial] firms.

THUROW, supra note 16, at 34.

84. Coffee, supra note 37, at 1302. Bank borrowing is the largest single source of capital, and banks handle most new issues of marketable securities, placing significant proportions of them with their customers. Cable, supra note 81, at 119.
curities underwriting.85 Moreover, given the proxy mechanism noted above, the bank may actually control a majority of the firm's voting stock.86 Banks also play an important role by influencing the occupancy of the firms' supervisory council in the two-tiered corporate board structure87 required by the German corporate legal system.88 Only Aktiengesellschaften (joint stock companies) may be publicly listed in Germany.89 These joint stock companies have a two-tiered management structure, composed of the Vorstand (management board) and the Aufsichtsrat (supervisory board).90 The management board handles the day-to-day running of the company, and the supervisory board oversees the management board, when necessary, and participates in long-term strategic decisions.91 The shareholders appoint the supervisory board, and the supervisory board appoints the management board.92 Individual shareholders have limited influence under this system, and are powerless to alter its structure.93

There are several possible relationships between banks and corporations in Germany, including: providing a range of commercial and investment banking services (the Hausbank function); representing small shareholders under the proxy system; sitting on the corporation's supervisory board; and owning a substantial block of the corporation's stock.94 The banks, as owners of shares, representatives of other shareholders, and often lenders to the company,95 tend to exercise their power in support of management.96 Banks, particularly in their role as lenders, also prefer a long-term strategy which emphasizes the

86. Buxbaum, supra note 34, at 36.
87. See infra text accompanying notes 90-92. See also Cable, supra note 81, at 125.
88. Buxbaum, supra note 34, at 37. German law requires that half the seats on the supervisory board be given to labor and employee representatives. Coffee, supra note 37, at 1315. Banks can influence the filling of positions (one-half of the total) on the supervisory board that the law does not assign to employees. Buxbaum, supra note 34, at 37. Banks can thus influence the choice of the CEO and, indirectly, the composition of the Vorstand (managing board). Id.
89. Schmalenbach, supra note 77, at 110.
90. Id.
91. Id.
92. Id.
93. Id.
94. Kübler, supra note 85, at 103.
95. Schmalenbach, supra note 77, at 111.
96. Id.
continued vitality of the company. The banks are well-suited to perform the monitoring function because the banks' ability to control a majority of shares in most public companies allows them to unilaterally remove directors if they wish. It is thus cost effective and profitable for the banks to monitor corporations. Moreover, the banks, as corporate “insiders,” have access to detailed financial information about the corporation and its long-range plans, thus reducing their risk of investment. The result is that banks do not require corporations to produce continuous improvements in short-term earnings, and corporations are able to make long-term decisions needed to maintain or increase their competitiveness in the international marketplace.

The conditions under which the German system developed help explain its dissimilarity to the American system. In close parallel to Japan, the German economic system developed as an important element of Germany’s strategy to remain politically and economically independent after World War II. Unlike corporate governance in the United States, the government of Germany, like that of Japan, was not interested in protecting the individual shareholders, but in protecting the entire country.

II. REDUCING SHORT-TERMISM IN THE UNITED STATES

Japanese and German banks are able to monitor and control corporations to a much greater extent than are their American counterparts. In the United States, the lack of shareholder participation fails to provide the accountability necessary to ensure that companies maximize their performance. In contrast, the Japanese combination of cross-shareholding and major shareholdings by the corporation's lenders provides stability, a long-term orientation, and insulation for Japanese corporate management from the short-term pressures often experienced by managers in the United States. Similarly, the German system concentrates the control of shareholdings in a few leading banks, which are capable of effective monitoring and are focused on the long-term business health of the corporation. This in-

97. Id.
98. JACOBS, supra note 9, at 70.
100. See JACOBS, supra note 9, at 63.
102. Id.
103. Id. at 220 n.101.
104. Id. at 220.
sulation from short-term pressures allows corporate management to build factories and to finance research and inventories that lead to increased international competitiveness. In both Germany and Japan, management is held accountable for its performance by informed participants.

A. THE CAUSES OF SHORT-TERMISM

The following discussion examines how access to capital, takeovers, and the prohibitive cost of corporate monitoring in the United States place pressures on managers to pursue short-term goals. This section concludes that bank ownership and monitoring of corporations can effectively reduce pressures on management to pursue short-term goals, allow for a longer-term view, and increase international competitiveness.

1. Access to Capital

U.S. corporations generally lack the long-term, low-interest capital to build factories and to finance research and inventories that are necessary to increase their long-term competitiveness. This lack of access to capital in the United States requires managers to pursue short-term strategies. Most U.S. companies carry roughly thirty percent debt and seventy percent equity. In contrast, in Japan most companies carry seventy percent debt and thirty percent equity. The difference between debt and equity instruments dramatically affects the cost of capital in two ways. First, because shareholders assume a greater risk, they expect higher total returns on equity than interest payments on debt instruments. Second, in the United States interest payments are deductible from taxes as a business expense while payments to shareholders are not.

105. See generally LOWENSTEIN, supra note 4, at 7.
In 1990, Japanese businesses spent nearly a trillion dollars on fixed capital formation — about a quarter of a trillion dollars more than was spent on new capital equipment in the United States and more than twice the amount spent on a per-worker basis .... The high rate of investment gives the Japanese a major advantage in incorporating new technology and upgrading products .... Fixed investment in Japan accounted for 33% of gross national product, compared with about 14% in the United States.

Japan: Japan's Vast Capital Investment Worsens U.S. Firms' Competitiveness, Expert Says, 8 Int'l Trade Rep. (BNA) 663 (May 1, 1991) [hereinafter Japan's Vast Capital Investment].

106. PRESTOWITZ, supra note 45, at 168.
107. Id.
108. Id.
109. Id.
U.S. corporations have less access to debt instruments than their Japanese and German counterparts due to a lower consumer savings rate and higher interest rates linked to the federal budget deficit. A low savings rate in the United States (approximately 4.2 percent in the last few months of 1992) results in a shortage of capital, which allows investors to demand high rates of return, and creates tremendous pressure for corporations to produce short-term profits. In Japan the rate of savings is about eighteen percent, and is the result of deliberate measures by the Japanese government to encourage savings. Moreover, low interest rates for industries and high interest rates for consumer loans are maintained in Japan.

In the United States, a significant source of capital for large corporations is the stock market. If a company's profits fall below expectations, even for a quarter, its share prices drop, thus increasing the cost of its capital and its vulnerability to financial raids. The high return demanded by U.S. investors explains why dividend payments in the United States are higher than dividend payments in Japan or Germany. In the United States, eighty-two percent of after-tax profits were paid out to shareholders as dividends in 1990. In contrast, in Japan, only thirty percent of after-tax profits were paid out as dividends in 1990.

110. See Karmel, supra note 34, at 71.
112. PRESTOWITZ, supra note 45, at 208.
113. Id. at 126. These measures include tax-free postal savings accounts, no consumer credit, the high cost of consumer goods, and a bonus-based salary system. Id.
114. Id. at 126-27. Japan's Key Technology Center provides capital investment for cooperative research and interest-free loans for high-risk technologies. Japan's Vast Capital Investment, supra note 105, at 663. Japanese firms are also assisted by Japan's Ministry of International Trade and Industry (MITI), which runs sixteen national laboratories, many of which are established for the purpose of assisting industry. Id.
115. PRESTOWITZ, supra note 45, at 208.
116. See Karmel, supra note 34, at 71.
118. THUROW, supra note 16, at 126. See also Coffee, supra note 37, at 1299. ("Japanese corporations historically have paid dividends equal only to approxi-
and twenty-eight percent in 1991. 119 Japanese companies are able to pay low dividends because the shareholders, as members of the company's *keiretsu*, gain by getting and giving preferential treatment to each other as preferred suppliers and customers, not by being paid dividends. 120 This strategy, combined with lower wages in Japan, leaves more capital in the corporation. 121 As a result of a lack of access to low-cost capital for U.S. corporations, the corporations are investing less in long-term market share, product development, and manufacturing technology in order to achieve the improved short-term earnings demanded by U.S. investors.

Finally, the "arms-length" relationship between banks and corporations in the United States results in greater borrowing risks (e.g., bankruptcy) than those found in Germany and Japan. 122 Because banks in the United States do not serve as directors or shareholders, they have less access to sufficient information about corporations and are often unaware of potential crises. 123 The result is that U.S. banks pursue a more conservative loan policy, lending significantly less than if more detailed information was available. 124 By comparison, bank ownership and monitoring in Japan and Germany results in greater access to information; consequently, lenders in those countries are more willing to renegotiate debt payments and extend new loans in times of distress. 125 Japanese and German corporations are thus able to operate under significant debt without increasing the risk of bankruptcy or compromising their long-term strategies. 126 This "flexible debt" is the product of greater willingness on the part of banks and their customers to...

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mately ten percent of the par value of their stock, and dividend yields as a percentage of the market value of shares are much lower, usually between one and two percent of market value. These figures would be extraordinarily low for most U.S. corporations.

121. *Id.* at 126. Statistics show that more than $1 trillion was removed from U.S. corporations over the past five years to pay for shareholder dividends and for stock buyback programs undertaken to boost share prices and keep potentially unfriendly shareholders happy. During the same period of time in Japan, capital flowed the other direction, adding $200 billion to the pool available to firms in Japan. Steven Pearlstein, *Summit's Big Debate: Where Is a Dollar Best Invested?*, WASH. POST, Dec. 16, 1992, at F1.
122. *See Jacobs*, *supra* note 9, at 146, 147.
123. *Id.* at 146.
124. *Id.*
125. *Id.* at 147.
126. *Id.*
establish close relationships. The mandatory “arms-length” relationship between banks and corporations in the United States makes it more difficult for corporations to obtain low-cost, patient investment capital in order to help develop companies and entire industries.

2. Takeovers

Many investors view takeovers as an effective method of monitoring corporate management. Passive shareholders who do not otherwise have an effective voice in corporate decisions can “vote” to remove poor management by choosing to sell their shares to corporate raiders when presented with a tender offer, rather than by “voting” for management by holding their shares. The number of companies which were destroyed or significantly altered by hostile takeovers in the 1980s, however, suggests that takeovers are a costly, ineffective, and short-term method of monitoring corporations. The threat of takeovers provides an incentive for management to defend itself by keeping share prices high in the short term, often at the expense of long-term growth. Share prices also determine the ability of a business to raise additional capital. High share prices come at a cost, however. By focusing the attention of corporation management on striving to maintain consistent profits at the expense of expanded research and development or new facilities, anti-takeover measures affect the long-term strategic decisions of management. In addition, the upheaval and expense resulting from takeovers is largely unnecessary because the problems companies face can often be solved by a change in

127. Id. Since the corporation’s lenders in Japan and Germany are also its shareholders and members of its economic group, the corporation has group support, and it is unlikely that the loans will be called. The loans are safe because the group implicitly stands behind them. PRESTOWITZ, supra note 45, at 169.

128. A “patient” investment strategy is one that involves marginal or no returns early on but eventually provides substantial returns in the more distant future. JACOBS, supra note 9, at 183.

129. Eckhouse, supra note 36, at C1.

130. See LOWENSTEIN, supra note 4, at 10-11.

131. A tender offer is an offer to buy all or a portion of the shareholders’ shares. See LOWENSTEIN, supra note 4, at 119.

132. See id. at 120-21.

133. See infra text accompanying notes 137-38.


135. Id.
management, rather than by a change in ownership.136

Although hostile takeovers are often justified as an appropriate corporate governance device in the United States,137 they present problems of cost and efficiency. Takeovers not only involve the opportunity costs discussed above, but also involve enormous transaction costs, involving legal, advisory, and financing fees.138 By comparison, hostile takeovers in Germany and Japan are extremely rare.139 This fact suggests that greater bank involvement may relieve some of the inefficiencies inherent in the market discipline system in the United States.

In Japan, keiretsu and cross-shareholding have created a system in which a large proportion of the equities held by banks and other corporate entities remains constant.140 The managers of Japanese firms are insulated from takeover raids, and can conduct business without building defenses which could preclude the accumulation of equity or inhibit long-term research and development strategies.141 As one author noted, "[t]o lengthen time horizons and accept a lower rate of return, impa-

137. Karmel, supra note 34, at 63.
138. "In a typical leveraged buyout in the 1980s, the legal, advisory, and financing fees averaged approximately 4 percent of the purchase price of the company, and more than 5 percent of the prevailing market value at the time of the offer." JACOBS, supra note 9, at 115.
139. See Viner, supra note 62, at 27; Schmalenbach, supra note 77, at 111; and JACOBS, supra note 9, at 115.
140. Aoki, supra note 15, at 14. Individual stockholders own only approximately 30% of outstanding total equities of list companies, and do not have an effective voice in the corporate governance structure. Id. Stable cross-shareholding is the primary takeover defense of Japanese corporations. Viner, supra note 62, at 28. By law, merger or acquisition is possible only with consent of all company directors, the vast majority of which are career employees. Id. at 29. See also Aoki, supra note 15, at 14. Cf. Sheard, supra note 58, at 408-09. However, Aron Viner argues that the incidence of takeovers in Japan, including hostile ones, is going to rise sharply for three reasons: (1) an increasing number of foreign firms are purchasing blocks of shares in Japanese corporations; (2) Japan's cross-shareholding system will be forced to be dismantled by the scrutiny of foreign investors demanding full reciprocity in the Japanese financial markets; (3) the Japanese courts have proclaimed that shareholders are investors whose interests need to be protected. Viner, supra note 62, at 31.
141. Viner, supra note 62, at 27. The efforts of takeover specialist T. Boone Pickens to obtain seats on the board of directors of Koito Manufacturing Co., a Japanese auto parts manufacturer, highlight the stability of the Japanese system. Pickens' firm, Boone Co., holds a 26.4% share in Koito, and is its largest shareholder.Japan: Koito Shareholders Veto Pickens' Proposals, Say 'No' to Board Seats at Annual Meeting, 7 Int'l Trade Rep. (BNA) 998 (July 4, 1990). Pickens' bid for four seats on the Koito board was rejected, however, even
tient consumption-oriented stockholders must be kept under control. The Japanese or German business groups have been organized to do just that.\textsuperscript{142} In Germany, like Japan, the structure of shareholdings effectively reduces (if not eliminates) the pressure on management to avoid takeovers, because the voting power is concentrated in the hands of the banks.\textsuperscript{143} As a result, in both Japan and Germany corporate management is able to concentrate on developing new products, reducing costs, and penetrating new markets, rather than maximizing share prices.\textsuperscript{144}

3. Monitoring Costs

Individual shareholders in the United States have little incentive to monitor corporations. Shareholders rarely hold large blocks of stock, limiting their ability (and willingness) to exert control or express opinions in relation to the management of the corporation.\textsuperscript{145} Moreover, shareholders do not have access to adequate information to make informed decisions about long-term investing.\textsuperscript{146} Shareholders do not become aware of problems within the corporation in time to correct them, and are powerless to correct the problems they are aware of.\textsuperscript{147} Shareholders obtain much of their corporate information from reported earnings, which fail to explain the merits of long-term expenses.\textsuperscript{148} The emphasis of U.S. investors on short-term earnings results in much greater research and development expenses for U.S. corporations, and their long-term international competitiveness suffers.\textsuperscript{149} The market mechanism of hostile takeovers provides at least one form of monitoring, but it is a highly expensive and

\textsuperscript{142} THUROW, supra note 16, at 134. For example, Japan maintains low interest rates for industries, and high interest rates for consumer loans. PRESTOWITZ, supra note 45, at 126-27.

\textsuperscript{143} See also Schmalenbach, supra note 77, at 111. In both Japan and Germany, management is free of the temptation to fashion “golden parachutes” (executive termination agreements between corporations and their executive personnel guaranteeing general severance benefits in the event of a corporate takeover) for protection against being fired following a takeover. PRESTOWITZ, supra note 45, at 156.

\textsuperscript{144} PRESTOWITZ, supra note 45, at 156.

\textsuperscript{145} See supra text accompanying notes 12-15.

\textsuperscript{146} Hazen, supra note 134, at 142.

\textsuperscript{147} Id.

\textsuperscript{148} See JACOBS, supra note 9, at 36.

\textsuperscript{149} See id.
inefficient one.\textsuperscript{150}

In addition to increasing the cost of monitoring, the paucity of information and prohibitive cost of obtaining it leads to greater market uncertainty. Inadequate corporate information results in greater risk to the investor, which generally increases the cost of capital and requires a corporation to produce short-term profits. Greater uncertainty can also result in attempts by management to defend against perceived takeover threats, and bank unwillingness to lend large amounts of capital.\textsuperscript{151}

In Japan and Germany, the shareholders are large and stable enough to monitor the corporations effectively.\textsuperscript{152} In Japan, the monitoring bank holds a significant stake in the firm as a shareholder, and is also the bank with the largest loan share.\textsuperscript{153} Such a significant interest often means that it is cost-effective and profitable for the bank to monitor the corporation closely.\textsuperscript{154} Moreover, the bank's involvement in the business and financial plans of the firm, and its access to regular reports of firm performance,\textsuperscript{155} lead to a close information-sharing system.\textsuperscript{156} The bank, as the major cash manager-creditor-stockholder,\textsuperscript{157} is able to detect problems of declining profits at a very early stage.\textsuperscript{158} The Japanese banks, unlike the individual shareholders in the United States, are able to obtain inside access to the firm. This access allows them to obtain information about the firm and its management which is not readily available, or available only at high cost to the external capital market.

Similarly, in Germany, bank borrowing is the largest external source of finance for corporations.\textsuperscript{159} Banks also handle most new issues of marketable securities, provide advisory and brokerage services in securing foreign, government and non-bank loans, and are widely represented on supervisory boards.\textsuperscript{160}

\begin{enumerate}
\item See supra notes 133-38 and accompanying text.
\item See supra text accompanying notes 122-24.
\item See generally Lipton & Rosenblum, supra note 46, at 219-21.
\item Sheard, supra note 58, at 406.
\item See id.
\item Id. at 403. This process of information exchange is often formalized by the main bank having a director link with the firm or through membership of a "presidents' club" in which the bank and other affiliated firms participate. Id.
\item Id.
\item Aoki, supra note 15, at 15 n.7.
\item The information is often gained from the management of commercial accounts, and long-term personal contacts with top management of the company and its business partners. Id. at 15.
\item Cable, supra note 81, at 119.
\item Id.
\end{enumerate}
Industry reliance on the banking system for access to capital and services results in substantial flow of information about corporate plans and performance to the banks.\textsuperscript{161}

4. Institutional Investors

Some would argue that non-bank institutional investors should be able to provide the large, stable, long-term investment strategies in the United States which banks have provided in Germany and Japan. However, although institutional investors hold large portions of all publicly traded U.S. shares,\textsuperscript{162} they have not actively assumed the monitoring function.\textsuperscript{163} Indeed, the Business Roundtable\textsuperscript{164} argued that "[u]nless institutional investors develop the ability to analyze and understand the long-term competitive performance of the companies in which they've invested, it's hard to see how their involvement in corporate governance will have a positive effect on corporate performance or U.S. competitiveness."\textsuperscript{165} Institutional investors have consistently engaged in passive short-term investment strategies, such as indexing,\textsuperscript{166} the use of derivative products, and program trading.\textsuperscript{167} Much of this is the result of legal restraints;\textsuperscript{168} however, it has been argued that even in the absence of legal restrictions, institutional investors would only moderately in-

\begin{itemize}
\item \textsuperscript{161}  \textit{Id.}
\item \textsuperscript{162}  "In 1980, institutions held 33 percent of all publicly quoted American shares. [In 1991], \ldots they are believed to own 45 percent." Karmel, \textit{supra} note 34, at 68. "By the end of 1989, pension funds owned an estimated 25-40 percent of publicly traded equities and they could own 50 percent by the year 2000." \textit{Id.}
\item \textsuperscript{163}  In 1989, institutions held 50 percent of the stock in the top fifty public corporations, 56.5 percent in the top 51-100 and 54.2 percent in the top 101-250. Moreover, institutional assets are heavily concentrated. At the end of 1988, the top thirty public and private pension funds held approximately 27.3 percent of the asset value of all such funds and 39.6 percent of the assets of the thousand largest funds.
\item \textsuperscript{164}  \textit{Id.} The largest class of institutional investors, pension funds, owned roughly 44\% of all institutional holdings in 1987. Matheson & Olson, \textit{supra} note 34, at 1355.
\item \textsuperscript{165}  \textit{See} Karmel, \textit{supra} note 34, at 69.
\item \textsuperscript{166}  The Business Roundtable is a business lobbying group which represents a group of two hundred chief executives from the nation's largest companies.
\item \textsuperscript{167}  Karmel, \textit{supra} note 34, at 85. (quoting Letter from H.B. Atwater, Jr., Chairman, Task Force on Corporate Governance, The Business Roundtable, to Linda C. Quinn, Director, Division of Corporation Finance, SEC (Dec. 17, 1990)).
\item \textsuperscript{168}  Indexes are portfolios of stock designed to mirror the performance of certain stock indices. \textit{See} Jacobs, \textit{supra} note 9, at 54.
\item \textsuperscript{169}  Karmel, \textit{supra} note 34, at 69. \textit{See also} Hazen, \textit{supra} note 134, at 137-39.
\item \textsuperscript{168}  \textit{See supra} notes 35-38 and accompanying text.
\end{itemize}
crease their participation in corporate governance.\textsuperscript{169}

There are several possible reasons for the lack of participation by many institutional investors. First, many institutional investors have adopted the practice of indexing, by which the investor holds a portfolio of stock designed to mirror the performance of certain stock indices, guaranteeing that they will do no worse and no better than average.\textsuperscript{170} Although this strategy may provide for longer-term investments, it fails to provide an economic incentive for investors to monitor corporations because investors are “guaranteed” to do no better or worse than average.\textsuperscript{171} Additionally, institutional investors do not have the resources necessary to monitor the large number of companies they own through an index fund.\textsuperscript{172}

Ownership behavior by institutional investors is also restricted by the unrelated business income tax (UBIT), a provision of the tax code which stipulates that if an institutional investor actively engages in providing direction to a company in which it owns stock, it may be entering that business.\textsuperscript{173} This is significant, because “engaging in a business” could expose the institutional investor to tax liability on that investment.\textsuperscript{174}

Conflicts of interest may also arise, leading to a short-term strategy of voting pro-management even when doing so is likely to decrease company value.\textsuperscript{175} For example, money managers who vote against a company’s proposals and develop an “anti-

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\item 169. \textit{Comparative Corporate Governance}, supra note 63, at 7. Other authors disagree, arguing that the dual position of many institutional investors as both bondholder and stockholder presents the kind of short-term conflict that could make them effective monitors. See Karmel, supra note 34, at 94-95. A few of the explanations for the lack of corporate monitoring by institutional investors are examined in the text below. See also Coffee, supra note 37, at 1317-28.
\item 170. \textit{Jacobs, supra note 9}, at 54. \textit{See also Lowenstein, supra note 4, at 64-65. Approximately one-third of all equity investments held by institutional funds are indexed. Coffee, supra note 37, at 1339.}
\item 171. \textit{Jacobs, supra note 9}, at 55. “[T]here is no economic incentive to participate in corporate governance, learn a company’s strategy, or vote their proxies. With indexing, investment dollars are spread so thinly across a large number of companies that improving the performance of a few would hardly influence their overall return.” \textit{Id.}
\item 172. \textit{Id.} There is also a “free-rider” problem: the institution would use time and resources to pursue a result that would benefit others as much as or more than itself, and the institution bears the entire risk of loss if the effort fails. Sommer, supra note 33, at 370.
\item 173. 26 U.S.C. § 512 (1988); Jacobs, supra note 9, at 49.
\item 174. “Pension funds guard their tax-exempt status carefully and avoid any action that could be deemed taxable.” Jacobs, supra note 9, at 49.
\end{itemize}
\end{small}
manager" reputation risk losing business with that company or may find it harder to gain new business.\footnote{176}

Monthly and quarterly performance reports promote short-termism by focusing the investor's attention on immediate gains rather than on long-term goals.\footnote{177} The compensation and continued employment of institutional investment managers are often linked closely with the performance of the plan, giving the managers of the plan incentive to use short-term strategies.\footnote{178}

Finally, fund managers are actually given incentives to maximize their short-term profits.\footnote{179} Boards of directors are required to consider takeover bids that raise share prices in the short term, even if they could harm the company in the long-term.\footnote{180}

Despite the impact of legal rules, conflicts of interest, and other obstacles, a few institutional investors are beginning to become more involved in the monitoring process.\footnote{181} Although proxy fights by institutional investors are still rare, some institutional investors now vote against management proposals on gov-

\footnote{176. \textit{Id.} Surveys indicate that institutions support management proposals between 59 and 74\% of the time. Coffee, \textit{supra} note 37, at 1293. For example, Dean LeBaron of the investment management firm Batterymarch has lost assets in part because of corporate displeasure with LeBaron's consistent opposition to anti-takeover measures put in by companies. Brett D. Fromson, \textit{The Big Owners Roar}, \textit{FORTUNE}, July 30, 1990, at 67.}

\footnote{177. \textit{Jacobs, supra} note 9, at 50. Some market professionals argue that mutual fund managers are more short-term oriented than pension fund managers because pension fund managers report their returns quarterly while mutual fund managers' results are in the newspapers every day. Laderman \& Smith, \textit{supra} note 35, at 63-64.}

\footnote{178. \textit{Prestowitz, supra} note 45, at 209-10. The Securities and Exchange Commission requires quarterly reporting of profits, while Japan requires only semi-annual reports. \textit{Id.} Investment advisers for mutual funds and pensions are compensated only by a small annual percentage of the assets under their control. Coffee, \textit{supra} note 37, at 1362-63. Compensation based on capital appreciation would provide more of an incentive for advisers to monitor, but the Investment Advisers Act of 1940 prohibits the use of any formula that "provides for compensation to the investment adviser on the basis of a share of capital gains upon or capital appreciation to the funds or any portion of the funds of the client." Investment Advisers Act of 1940, § 205(a)(1), 15 U.S.C. § 80b-5(a)(1) (1988). \textit{See Coffee, supra} note 37, at 1363 n.337.}

\footnote{179. \textit{Prestowitz, supra} note 45, at 210.}

\footnote{180. \textit{Id.}}

\footnote{181. One reason for this new activism is that institutional investors increasingly own large unmarketable blocks of stock and must accept substantial price discounts in order to liquidate those blocks. Coffee, \textit{supra} note 37, at 1288-89. As a result, some institutional investors are choosing to become involved in governance decisions rather than sell their stock. \textit{Id.} at 1289. For an examination of corporate managements' reaction to increasing institutional activism, see Terence P. Pare, \textit{Two Cheers for Pushy Investors}, \textit{FORTUNE}, July 30, 1990, at 95.}
In 1989, institutional investors presented 215 governance proposals. As of August 1990, 285 governance proposals had been presented for the year. The number of institutional representatives that sit on corporate boards is growing. The California Public Employees Retirement System (CalPERS) and Warren Buffett's Berkshire Hathaway are notable examples of monitoring efforts by institutional investors. CalPERS has been willing to commit substantial capital to policing the performance of some companies in its index. As of late 1989, CalPERS had sponsored twenty-eight shareholder proposals and has sought to reform the proxy rules. Similarly, Berkshire Hathaway purchased large stakes in a number of companies, and Buffett took over as CEO of Salomon Brothers after a scandal forced the former CEO to resign.

Nevertheless, institutional investors, for the most part, have not been able to provide the stable, long-term investment strategies in the United States which banks have provided in Germany and Japan. Even though institutional investors are large enough to monitor corporations in a cost-effective manner, legal rules and conflicts of interest prevent them from mitigating their risk of investment by obtaining adequate information about the corporation and its long-range plans. As a result, most institutional investors, like individuals, require corporations to produce increasing short-term earnings at the expense of long-term growth.

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182. Black, supra note 175, at 814.
183. Matheson & Olson, supra note 34, at 1357.
184. Black, supra note 175, at 829. "Robert Kurby of Capital Guardian Trust and Frank Savage of Equitable Capital Management were appointed to the Lockheed board to fulfill Lockheed's promise, made during a 1990 proxy fight, to appoint institutional representatives. In 1991, Tiger Management won a proxy fight to appoint five directors to the board of Cleveland-Cliffs." Id.
185. JACOBS, supra note 9, at 55. CalPERS, one of the nation's largest institutional investors, invests pension funds for more than 950,000 public employees throughout California and has assets valued at approximately $71 billion. Lawrence M. Fisher, Big Pension Fund Prodding 12 Companies, N.Y. TIMES, Jan. 23, 1993, § 1, at 36. At Honeywell, CalPERS and the Pennsylvania Public Schools Employees' Retirement System helped launch a proxy battle that led management to restructure the company, with highly successful results. Fromson, supra note 176, at 67. CalPERS is the exception, and Executive Director Dale Hanson admits that his fund gets involved only in the case of consistent underperformers. JACOBS, supra note 9, at 55.
187. Black, supra note 175, at 846.
B. A Possible Solution: The Modification or Repeal of Glass-Steagall

Having concluded that bank ownership and monitoring of corporations in Japan and Germany reduces pressures on managers to pursue short-term strategies, this Note now turns to the future of bank monitoring of corporations in the United States. More specifically, this section examines recent proposals to modify or repeal certain provisions of the Glass-Steagall Act, discusses the existence of continuing safeguards which are necessary to ensure the continuing stability of the banking industry, and considers political and cultural factors which may affect the feasibility of modifying or repealing the Glass-Steagall Act.

1. Proposed Banking Reforms

Legislators in both the United States House of Representatives and Senate have recently introduced bills proposing the repeal of the Glass-Steagall Act. Even more clearly than the regulations and interpretations of the Glass Steagall Act discussed below,188 these proposed reforms suggest that bank ownership and monitoring of corporations may, in the future, be available in the United States. The Comprehensive Deposit Insurance Reform and Taxpayer Protection Act of 1991189 contained provisions to repeal the Glass-Steagall Act.190 Before consideration of the legislation by the Senate, however, the provision was eliminated.191 Similarly, the Financial Institutions Safety and Consumer Choice Act of 1991192 included provisions to repeal the Glass-Steagall Act along with provisions to amend the Bank Holding Company Act. Significantly, the House Committee noted that it had not been persuaded to repeal Glass-Steagall because it believed that the securities industry had sufficient excess capacity to enhance the profitability of the banking industry.193 Rather, the Committee determined that: (1) most of Glass-Steagall had been administratively repealed already; (2) product innovations and technological advances had rendered an absolute separation between commercial and in-

188. See infra text accompanying notes 199-204.
190. 137 CONG. REC. S17341-01, S17375 (1991) (remarks by Mr. Garn).
191. Id.
vestment banking functionally impracticable; and (3) other effective safeguards strong enough to protect the public against the evils Glass-Steagall sought to abate could be fashioned and enforced.\textsuperscript{194} The full House of Representatives defeated the bill on November 4, 1991.\textsuperscript{195}

These proposals, combined with several new bills introduced in Congress in 1992,\textsuperscript{196} indicate a movement toward substantial banking reform. These reforms may have a significant effect on the ability of banks to own and monitor corporations in the future.

2. Effective Safeguards Remain

As noted earlier, the Glass-Steagall Act was passed in response to congressional concerns that the largely unregulated actions of banks after the stock market collapse and during the Great Depression led to conflicts of interest, fraud, and the failure of many banks.\textsuperscript{197} Any proposal suggesting the modification or repeal of the Glass-Steagall Act, therefore, must address the effect of that modification or repeal on the continued stability of the banking system. There are several reasons to believe that modifying or repealing Glass-Steagall will not increase risk and bank abuse.

First, the separation of commercial and investment banking is so riddled with exceptions that it is difficult to support the contention that eliminating the remaining restrictions would seriously imperil the banking system.\textsuperscript{198} Although Congress has not amended or repealed the Glass-Steagall Act, federal and state regulators have significantly expanded the scope of bank power.\textsuperscript{199} In 1977, federal bank regulators interpreted Glass-Steagall as permitting banks to serve as agents with respect to the private placement of securities.\textsuperscript{200} In 1985, banks were permitted to serve as advisers to open-end mutual funds, provide advice to bank customers about a fund, and obtain commissions

\textsuperscript{194} \textit{Id.}
\textsuperscript{195} \textit{H.R. REP. NO. 455, 102nd Cong., 2nd Sess. 79 (1992).}
\textsuperscript{197} \textit{See supra text accompanying notes 16-22.}
\textsuperscript{198} \textit{See Tavelman, supra note 19, at 1511.}
\textsuperscript{199} \textit{Id.}
\textsuperscript{200} \textit{Id.}
from the mutual funds in whose shares a bank customer invested.\textsuperscript{201} In 1987, national banks were given the authority to underwrite and deal in interests in certain securities.\textsuperscript{202} In September 1990, for example, J.P. Morgan & Co. was granted permission to underwrite and deal in corporate stocks through a non-bank subsidiary.\textsuperscript{203} In January 1991, three additional banks were granted the power to underwrite and deal in equity securities.\textsuperscript{204} These regulations and interpretations have significantly relaxed the original provisions of the Glass-Steagall Act.

More importantly, activities permitted under Glass-Steagall today are arguably no more risky than those currently prohibited by the Act.\textsuperscript{205} In fact, most recent bank troubles have arisen from such traditional banking activities as real estate loans, energy loans, and loans to developing countries, not from securities transactions.\textsuperscript{206} Finally, any risky behavior by banks can be constrained by proper regulatory oversight and by the banks' desire to maintain a favorable reputation in the financial markets.

3. Additional Considerations

In anticipating potential criticisms to a proposal advocating an increase in the ability of U.S. banks to own stock and monitor corporations, a few points are worth noting. First, the control of the keiretsu system in Japan and that of the bank-centered system in Germany appears to be decreasing.\textsuperscript{207} In Japan, some of the larger companies are starting to secure capital from the international capital markets, thus circumventing their banks.\textsuperscript{208} In addition, the ratio of intra-group transactions is declining.\textsuperscript{209}

\textsuperscript{201} Id.
\textsuperscript{202} Id. This decision was upheld by the Second Circuit in \textit{Securities Industry Ass'n v. Board of Governors of the Fed. Reserve Sys.}, 839 F.2d 47 (2d Cir. 1988), \textit{cert. denied} 108 S.Ct. 2830, 100 L.Ed.2d 931 (1988).
\textsuperscript{205} For example, Glass-Steagall restrictions do not restrict banks from selling mutual funds. \textit{See} Leslie Wayne, \textit{Banks Venture into Mutual Fund Territory}, HOUS. CHRON., Dec. 31, 1992, at 1.
\textsuperscript{206} Tavelman, supra note 19, at 1511 (citing Stephen J. Friedman & Connie M. Friesen, \textit{A New Paradigm for Financial Regulation: Getting from Here to There}, 43 MD. L. REV. 413, 451 (1984)).
\textsuperscript{207} \textit{Comparative Corporate Governance}, supra note 63, at 7.
\textsuperscript{208} \textit{JACOBS, supra note 9}, at 150.
In Germany, the equity held by German banks in major corporations has been steadily decreasing.\(^{210}\) Consequently, banks hold fewer board seats, and are less inclined to incur monitoring expenses.\(^{211}\) Rather than proving conclusively that bank monitoring is undesirable, these changes indicate that as international credit markets have become available, some Japanese and German corporations are willing to trade security for lower rates.\(^{212}\)

Second, there is a significant structural difference in the number of companies listed on stock exchanges in Germany and those in the United States.\(^{213}\) In Germany, most companies are privately held, and only about seven hundred of the three hundred and eighty thousand companies in Germany are listed on a public stock exchange.\(^{214}\) Owners and managers of privately owned companies do not suffer from the same conflicts of interest that exist between owners and managers of publicly held corporations, because they are often one and the same.\(^{215}\) This Note does not suggest that the German and Japanese systems can be brought to the United States in their current form; rather, it suggests that the Japanese and German corporate governance systems, although structurally different than that of the

(JFTC) conducted a study of six Japanese keiretsu (Mitsui, Mitsubishi, Sumitomo, Fuyo, Sanwa, and Dai-Ichi Kangyo) and found that the average ratio of intra-group stock holdings per group firm is decreasing, that personnel relations between firms is declining, and that average intra-group transaction volume is falling. \(\text{Id}\). The study concluded, however, that the six keiretsu retain a significant position in the Japanese economy. \(\text{Id}\). Congressional Research Service's Dick Nanto said that "[t]he conglomerate keiretsu is likely to grow rather than to shrink, although coordination among member companies is likely to diminish as individual companies become more independent and networking outside the keiretsu system becomes more common." \(\text{Japan: Japan Not Likely to Overtake U.S. Economy, But U.S. Not Meeting Challenge, Experts Say, 7 Int'l Trade Rep. (BNA) 1582 (Oct. 17, 1990).}\) On March 11, 1992, Matsushita Electric Industrial Co. announced that it would unravel its keiretsu ties with retailers, the first Japanese firm to do so. \(\text{Japan: Matsushita Electric Becomes First Japanese Firm to Break Keiretsu Ties, 9 Int'l Trade Rep. (BNA) 493 (Mar. 18, 1992).}\) The move was prompted by stricter anti-monopoly guidelines in Japan. \(\text{Id}\).


211. \textit{Id}\.  

212. \textit{JACOBS, supra} note 9, at 150. \textit{See also Comparative Corporate Governance, supra} note 63, at 7. \textit{See also Coffee, supra} note 37, at 1305-06.

213. By the end of 1988 only 706 of the approximately 380,000 German companies were listed on any of the eight German stock exchanges. Of these 706 companies, only some 50 have a significant weight in the market. \(\text{Schmalenbach, supra} note 77, at 109. \) "A[pproximately eight thousand American firms are available candidates for institutional investment over public share exchanges as against, at the most, eighty German firms."

214. \textit{JACOBS, supra} note 9, at 69.

215. \textit{Id}\.
United States, may illustrate useful elements for those interested in leading U.S. corporations to an increasingly competitive, longer-term view of investment.

Third, increased institutional investment and bank monitoring may lead to violations of insider trading and antitrust provisions. However, given the heavy civil and criminal sanctions against such actions, strong SEC and stock exchange enforcement efforts, and the interest of institutional investors in avoiding adverse publicity, the institutional investor has little incentive to violate these provisions. Moreover, the risk of insider trading and collusion is controllable through the use of outsiders to fill board seats, decreasing the risks of insider trading and possible conflicts of interest.

Finally, there are significant political and cultural differences between the United States, Japan, and Germany which may impact the feasibility of modifying or repealing the Glass-Steagall Act. In the United States, “[t]he individual is king and government exists to keep corporations from harming the consumer.” The repeal of the Glass-Steagall Act may be undesirable to those who highly value individual freedom because it may, to a large extent, freeze individual investors out of corporate ownership. In addition, even if individual shareholders still have access to corporate ownership, the powerful interests of the bank may override those of the individual shareholders. Even given these concerns, it is clear that there is a strong movement

216. Antitrust violations are a concern because a large stockholder who owns stock in competing companies could facilitate price fixing, or other collusive behavior. Black, supra note 175, at 870.

217. If found in violation of insider trading regulations, an institution could be liable for compensatory damages to contemporaneous traders and to the SEC for a civil penalty of up to three times its profits. See Securities Exchange Act of 1934, §§ 20(a), 21(a), 15 U.S.C. §§ 78t(a), 78u(a) (1988). See also Coffee, supra note 37, at 1345 n.259.

218. Black, supra note 175, at 868-69.

219. Id.

220. Eckhouse, supra note 36, at C1. This system is often described as individualistic, finance or consumer capitalism. Id. Corporate governance in America protects shareholders' rights to a firm's ongoing earnings and residual value, while the interests of other participants (e.g., suppliers, customers, employees and creditors) are not as directly protected by this process. Comparative Corporate Governance, supra note 63, at 6. Adversarial relations between government and the private sector are deeply imbedded in American history. Thurow, supra note 16, at 38-39. See also Buxbaum, supra note 34, at 29. ("This drive [for profit maximization] . . . takes place, at least in the United States, within a cultural frame of reference that sees labor and capital as antagonistic competitors.").
toward modification or repeal of the Glass-Steagall Act.\textsuperscript{221}

III. CONCLUSION

The corporate governance model of bank ownership and monitoring offered by Japan and Germany may be of great utility in modifying the current system of corporate governance in the United States. The Japanese and German corporate governance systems appear to be more suitable to a competitive international marketplace than the model of accountability by managers and directors to stockholders that currently prevails in the United States. Pressures on managers in the United States to pursue short-term goals jeopardize international competitiveness by making research and development and the building of new facilities prohibitively costly. The foregoing discussion suggests that a modification or repeal of Glass-Steagall, allowing banks to own stock in and monitor corporations, decreases the cost of capital for investment by reducing risk and increasing the amount of information available to the investor. This, in turn, will lead to long-term international competitiveness. The decreasing power of banks in Japan and Germany, however, leads to the conclusion that bank monitoring alone is not the answer. Rather, as international capital markets gradually supersede internal capital markets, bank control will inevitably be weakened. Therefore, the repeal or modification of the Glass-Steagall Act should be accompanied by modifications to provisions limiting the ability of other institutional investors to own stock in and monitor corporations. Banks and other institutional investors in the United States have the capability to be effective monitors, they simply lack the legal ability.

\textsuperscript{221} See, e.g., 137 CONG. REC. S17341-01, S17376-17377 (1991) (Letter from more than 70 companies and users of financial services to Senator Garn of the Banking Committee, urging the repeal of Glass-Steagall).