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Over the last five years, my mission at Nomura Securities International has been to build an American securities company as part of a Japanese company. Within that mission I have had two principle goals: first, to build a profitable company; and second, to create a company that can help and be part of the global organization which is Nomura Securities Company.

Background

A number of factors have combined to create an environment not entirely conducive to achieving this mission.

Since joining Nomura in 1989, every year for the last five years we have experienced a new anniversary of the history of World War II, from Pearl Harbor to the atom bomb, and every time that happens we get a bomb threat. These events have not had a positive impact on American-Japanese relationships, as reflected, in part, in the unwillingness of regulators and customers to deal with Japanese companies.

At the same time, the Japanese investor and the Japanese market have gone through a tremendous tailspin. In 1989, the Nikkei was at almost 40,000 and Nomura Tokyo was earning 3.5 billion dollars pretax, but by last year, the market was down 65 percent and Nomura's profits had declined substantially. This had a significant influence on Japanese investor behavior and the willingness of the parent company to spend a lot of money somewhere other than Japan.

I can also argue that I was the wrong person to do this job. First, I don't look very Japanese. I grew up in North Carolina, and my father was a marine officer who spent a lot of his career from Gaudalcanal to Okinawa. I was a marine officer myself, my education is U.S., my business experience is U.S., so why me?

Another handicap was the company itself. In 1989 Nomura was the largest securities firm in the world, earning 3.5 billion dollars with 20 billion dollars in capital, which today is equal to the sum total of the capital of the top four U.S. securities firms. The hardest thing to do is to change a successful company, because there is no sense that it needs to change. Why spend a lot of time and money worrying about a bunch of Americans who have not made any money in 50 years? In fact, it would seem that Nomura had already figured it out and the Americans had not. Or so it seemed at the time.

What Does Globalization Mean?

There is no question that communication, transportation, and capital are all going international – the world is indeed getting smaller. But what does globalization mean from a business standpoint? In most conversations about globalization, people talk about control – either control of the profit stream around the world, or control of the technology, or control of the product, or a sum of all these. My proposition is that is wrong.

If you look back in history and consider examples of people who have tried to control the world – whether it be the Romans, the Spanish, the British, the Germans, the Japanese, the Russians, or even the Americans – you will see that they all failed. They failed because part of human nature is that people want to be independent. One of the great things that has happened in this world over the past 20 years is that people have realized dictatorships and communist systems do not work – people want to run their own lives. So why should we expect from a business standpoint to be able to go into a market and control people's economic livelihood, or their products, or their technology? Consider, for example, Japanese efforts to globalize the automotive business. Japanese firms have taken a process of building a cost efficient automobile and transplanted it in certain places and produced a good product. But I would not necessarily say these firms are global in the sense of controlling product, distribution, or technology. Another example is the U.S. securities business. Many U.S. securities firms have simply taken their financial technology and American management approaches and applied them to inefficient markets; they have not controlled or even become a part of the local market in terms of distribution, product development, or culture.

Therefore, when we think about globalization we need to focus on how to gain access to local channels of distribution, local management techniques, and local resources. We need to ask: How does a firm become part of the local culture and the local market? Firms like McDonalds and Coca Cola have probably come as close to doing it right as any company because they find local partners and make their products work in that marketplace.

U.S. v. Japanese Culture and Business Practices

Almost everything I believe about how a business ought to be run appears contradictory to the way businesses are run in Japan. I am not being critical of Japan or the Japanese financial system – it is a tremendously successful country. But Japanese society is different – not better or worse – just different. Americans tend not to place as much importance on understanding cultural differences as we should, and this can cause problems.

America is a multi-cultural society. Historically we have found great strength in the diversity of our population, and therefore the concepts of independence and self-identity have been very important to America. The glue that holds this together is the legal system; it is not a culture. Japan is predominantly a mono-cultural society, and therefore the cultural aspects of the society are the glue that holds it together.

Several important differences are worth mentioning. First, Japanese and English are diametrically different languages and this makes simple communication an issue. Second, the legal environment is different: in Nomura Tokyo there are two full-time lawyers; in America we have 23 lawyers in a company one-twentieth the size. These legal differences are reflected in the regulatory system and the contrast between the Securities Exchange Commission (SEC) on the one hand and the Ministry of Finance (MOF) on the other. MOF is a very loose organization in terms of communication through informal channels, but there is nothing informal about the SEC – the rules are written down and you live by them. In Japan, there are not many things written down so you have to keep lines of informal communication open.

A third difference is corporate structure. In Japan, there is the permanent employment system with rotating employees who hope to be with the company for life. These employees will rise in the organization based upon seniority and on how well the company in total does. In contrast, here in the United States, I do not have one American employee who is looking more than two or three years ahead, or perhaps through the next bonus payment. So there is this difference between what I call a free-labor market in America and a semi-permanent labor market in Japan which creates a whole new class of issues and problems.

Another issue is collective responsibility versus individual initiative. In the United States there is a concept that individuals are responsible for their decisions; they will take a risk because if they are right they will be rewarded. But under the Japanese system that does not exist: take a chance and fail, and you are in real trouble; take a chance and win, and you will merely continue to rise within the company along with your peers. These different concepts of risk-taking also tie in with fundamental differences in decision-making processes. In America, the decision process is top-down: somebody makes a decision and is willing to take the risk inherent in that decision. In a Japanese company, decision-making is through consensus, a bottom-up process. The net result can be either good or bad. In the United States, making a decision and acting upon it can be done relatively quickly, even though sometimes the decision will be wrong. In the Japanese system it takes a long time to make a decision, but when it is finally made there is agreement. The difficulty is that when you are trading in a fast market that process does not usually work particularly well.

A final difference is that between Japan's male-dominated environment and the current American EEOC-dominated environment. When I attend general managers meetings in Japan with 400 or 500 people, I have yet to encounter a woman there other than those serving tea. Of course the goal is to change that, but the reality is somewhat different.

On all of these issues, there is movement for change. The differences are not absolute: the American system is breaking down in some places, and so are many fundamental aspects of the traditional Japanese system. But in terms of trying to build a company, we have to deal with the current reality, and history shows that Japanese-style management will not work on

Wall Street. In fact, Nomura Securities has been in America since 1927, and for 50 or 60 years they had managed their operations in the Japanese style. But that system did not work: Nomura never made any money because they could not retain employees or develop the skill base necessary for competing in the most competitive financial market in the world. Clearly, the system had to change.

<u>Nomura's Strategy in the U.S. Securities Business</u>

Given these differences in culture and business, we decided not to follow a Japanese approach or even some hybrid approach which might take the best (or sometimes the worst) from each system, but to embark on a uniquely American approach to building a securities company in the United States within a Japanese organization. At first, in the mid-1980s, there was some discussion of buying either Merrill Lynch or Salomon Brothers – when a company is making 3.5 billion dollars a year it can potentially buy anybody it wants. In fact, my original involvement with the company began when General Electric had the idea of selling 40 percent of Kidder Peabody to Nomura. For over a year I went back and forth to Japan trying to negotiate the deal. But when the crash came in 1987 Nomura decided against doing that and instead to build on the business it already had and use American management to do it.

What were the principles we tried to employ in building an American company? First we asked for a high degree of self-sufficiency; American management had to be given the authority to make decisions and, potentially, mistakes – what I call freedom to operate in the market.

Second, recognizing that the securities business is a people business, our strategy was skill based. We set out to attract and retain the most skillful people in our business, those who could operate successfully in this environment. Unlike financial markets in Japan, Wall Street is no longer an agency business. Commission revenue on Wall Street is probably less than 10 percent of gross revenues today; the majority of revenue comes from principal trading, or committing capital. And if a company is going to commit capital, its employees have to understand risk, they have to understand the market, and they have to be able to make decisions quickly.

Third, since I joined Nomura, we have operated on a duality management system. The Japanese co-chairman and I work together in a successful partnership by dividing the responsibilities in terms of respective skills and capabilities. Clearly, my responsibility and effort in the U.S. operation is concentrated on building the businesses and control systems, while my co-chairman works on the relationship with Japan, our Japanese clients, and our Japanese employees in the United States, helping to integrate them into our system and finding places where their talents can truly be used.

The final principle underlying our strategy at Nomura is the concept of local ownership. The notion of ownership in a business is critical; to work for a salary and not have any sense of ownership is very difficult. Within a global context, if you are a Japanese permanent, rotating employee, you have already have a sense of ownership because it is your company and your life. In America that is not the case, so we have to find ways – whether it is through phantom stock or earnings incentives – to make employees feel that they really do own something and can participate in it.

Operating from these four principles, we then employed a specific strategy of skills, capital, access and profits. The basic theory is to first gain a skill level in a particular market and then use Nomura's major resource – which in America is capital – where we are good at it. In the United States, Nomura does not have long investment banking relationships or massive distribution capability; we have capital and credit – that is our strength. There are many companies that come into this country and decide to build a sales force to access the customer and then see if they can sell their product. This is like going onto a super highway from a stop sign – you try going onto that highway and you will get run over. So the goal is to get yourself up to speed so you can merge in with the flow of business. The way you do that is by building up your skills and committing your own capital; see if you are any good at it before you represent yourself to a customer saying you can do it for them. Once you have done that, then go out and access the customer and use your skills to create the products the customer wants. It has been precisely that sequence we have used within the concept of building business units at Nomura.

Historically Wall Street has been arbitrarily divided into fixed income, equities, investment banking and research, and Nomura was exactly that way. But we rejected this notion and decided to build business units that had all the requisite capabilities contained within one unit. So within a high yield department, for example, there would be sales, training, research and financing divisions all reporting to the same management group, with that group controlling both the revenue and expense for the unit. The idea is to create an environment in which the leader of the business unit perceives that he can build a really significant business. But at the same time, each business unit must be supported very extensively by an underlying support structure, which includes risk management and a control system with compliance, audit and regulatory functions. Recent examples show that maintaining this balance of leverage and control is critical to the success of the business.

Following this strategy we have built business units in areas where Nomura had some relative advantage given our capital and our global access capability. Success in these units has been based on individual responsibility and pure meritocracy; people are rewarded in a very high manner relative to their profitability. As a result, some of the highest paid people working on Wall Street today work for Nomura Securities.

The Results

The results of this strategy have been very good for Nomura, and success has ranged over a number of business units.

First is the commercial mortgage business. We hired some bright young people in the business and gave them some capital to see if they could trade profitably on the commercial side. When they did, we found a gap, and using the technology we had developed from the residential CMO business, we applied our capital in an area where not many people were competing. As a result, Nomura has become the primary underwriter of commercial loans in this country, doing some 12 billion dollars of business over the last three years. This week we have just completed a 900 million dollar transaction which is one of the most successful securitized commercial loans ever done.

Another successful business for Nomura is mortgage arbitrage. About two and a half years ago Nomura got out of the conventional CMO business because it was taking increasing amounts of capital and a major expansion of sales forces to remain competitive at relatively low levels of profitability. But taking a by-product of that process, namely IO/PO inverses, we applied our technology and began dealing in the market for mortgage derivatives. Nomura now has two Cray computers dedicated solely to this trade, and we are running 40,000 to 50,000 calculations a day on 23 different hedge models for this portfolio. Nomura has become the pricing mechanism on the Street for understanding inverses and floaters.

A third business is in high yield which we started about 18 months ago. Bringing together sales, training, research and finance, we set up a three hundred million dollar mezzanine fund to gain access to clients, and we committed five hundred million dollars to bridge loans. Today we have a nice profitable niche we can play not based on historical relationships but on capital and skills.

Nomura is also a major player in the distress securities business. By buying a second derivative of junk bonds, Nomura can gain control and reorganize the capital structure of corporations.

Nomura is also in the equity derivatives business. By starting in the program trading business and expanding that into package trading, we are now looking at building indices on foreign markets and creating swaps and options on those indices, a profitable business for us.

The final area I mention is our Asian equities business, in which we have considerable international credibility given Nomura's position in Japan and our distribution capabilities here. Nomura is ranked number one in Japanese distribution, and if and when the Japanese market comes back, we will be in a very good position to participate in this process, which is where the profit is in the equity business.

In each case, our success has followed the exact sequence of skill, capital, access to customers, and creating product. In terms of the business units we have and our strategy for capital implementation, Nomura New York has done a good job within the current market environment. From five years ago, when 90 percent of our business was based one way or another in Japan, today less than 5 percent of our business is Japan related. We have become a very successful American securities company. The revenue of Nomura New York this year should exceed one billion dollars, with pretax profit over 350 million dollars and after-tax return on equity exceeding 40 percent. We currently operate with approximately 1.1 billion dollars of regulatory capital, comprised of 500 million dollars of equity supplemented by subordinated debt of 600 million dollars. We have a credit guarantee of a billion and a half dollars from our parent company that we use for commercial paper and medium-term notes to finance our business. Nomura currently employs about 1,000 people of whom approximately 45 are Japanese, up from the 450 total employees of five years ago when we had 70 rotating Japanese staff.

In terms of our goal of building a profitable, global company, I would argue that we have met half that goal. We have created a very profitable business with the capital we have been provided based on an American model that works in this market. However, we have not yet figured out how to connect this business with the rest of the world in terms of different cultures and business processes. Nomura in Tokyo is still predominantly an agency commission-based business. And now, because of increasing volume in Japan, their profitability is up from a year ago. The next challenge is to take the skill base we have developed and connect it with the rest of the company.

The vision we have at Nomura is one that was expressed by a past president of Nomura some years ago – to create a company that does not have one central heart, or where there is not one central location that pumps blood everywhere else in the organization. Rather, the model that works for us is that of a number of very healthy parts which can survive in their local environments and provide blood and nutrients for the rest of the body. While we have created a viable organization here in the American market, now we have to do the same thing in other parts of the world.