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JAPAN'S FINANCIAL SYSTEM REFORM LAW: PROGRESS TOWARD FINANCIAL LIBERALIZATION?

*Thomas F. Cargill and Gregory F.W. Todd**

I. INTRODUCTION

Liquidity is not distributed among economic agents in accordance with their spending desires: some agents — deficit agents — desire to spend more than they receive, while others — surplus agents — desire to spend less than they receive. The transfer of excess funds from surplus agents to deficit agents is an essential function of each society's financial system, despite the many differences in those systems. Banks have traditionally played a major role in the transfer of funds from surplus to deficit units.

Japan's financial system began a transition in the mid 1970s that has yet to be completed.¹ The transition was initiated by a series of economic and technological forces manifested by oil-price shocks, government deficits, a shift from a fixed to a flexible exchange rate regime, and advances in computer and telecommunications technologies that permitted market innovations such as the Euromarkets. Market innovations and regulatory reforms have reduced barriers between previously distinct financial and regulatory structures, increased the role of market forces, and changed financial markets and institutions from rigidly regulated and administratively controlled structures to more open and competitive ones. This process is referred to as "financial liberalization" in Japan, whereas in the United States the process is referred to as "deregulation."

The process of financial liberalization in Japan, as in the United States, has eroded the banks' market share in the flow of funds by exposing them to competition from non-bank financial institutions in both deposit markets and in loan markets. During

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1. A taxonomy of financial change applicable to any country is presented in THOMAS F. CARGILL & SHOICHI ROYAMA, *THE TRANSITION OF FINANCE IN JAPAN AND THE UNITED STATES: A COMPARATIVE PERSPECTIVE* 92-95 (1988).

the 1980s Japanese borrowers became increasingly able to access the Euromarkets for long-term funding, while the Japanese pension funds and insurance companies, with ever larger reservoirs of funds to be invested in portfolio securities, were ready purchasers of such borrowers' securities. Borrowers found lower cost funding than that available within Japan, cutting the banks out in the process. Bank profits and capital have also declined during the past decade, while at the same time BIS standards on bank capital have caused Japanese banks to shed loan assets in order to enhance capital ratios.

The Japanese banks have been constrained in responding to these developments in part by Article 65 of the Japanese Securities and Exchange Law, enacted during the Allied Occupation (Occupation) of Japan. Like the United States Glass-Steagall Act,² Article 65 imposes a strict separation between banking and securities activities.³ The question of broader bank powers has therefore been a heated issue in Japan, and bank lobbying for repeal of Article 65 has intensified as banks have lost market share in their traditional deposit and loan markets to securities firms.

In June 1992, following nearly five years of discussions and reports by private groups and committees appointed by the Japanese Ministry of Finance (MOF),⁴ the Japanese Diet enacted a wide-ranging financial reform law⁵ that, among other measures,

2. Sections 16, 20, 21, and 32 of the Banking Act of 1933, Pub. L. No. 73-66, 48 Stat. 162 (codified as amended in scattered sections of 12 U.S.C.), collectively referred to as the Glass-Steagall Act, prohibit (i) banks from investing in or underwriting corporate securities; (ii) banks from affiliating with securities firms; (iii) securities firms from engaging in the business of deposit-taking; and, (iv) bank directors, officers, and employees from serving as directors, officers, or employees of securities firms.

3. Although Article 65 applies only to securities activities of banks, the Banking Law of Japan, Law No. 59 of 1981, restricts banks from engaging in any activities other than banking and matters appropriately related thereto. *See infra* note 34. The question of expanded bank powers therefore also expands to matters such as insurance powers and cross-ownership between banks and nonfinancial firms, which are currently under study in Japan.

4. *See infra* note 73 and accompanying text. A brief summary of these discussions can be found in Shoichi Royama, *On the Financial Reform in Japan*, in CAPITAL MARKETS AND FINANCIAL SERVICES IN JAPAN 2, 4-7 (1992).

5. Law Concerning the Realignment of Relevant Laws for the Reform of the Financial System and the Securities Trading System, Law No. 87 of 1992, translated in *The Amendment to the Securities and Exchange Law to Insure the Fairness of Securities Trading* (Part I), CAMRI REV., Apr. 1992, at 2; *The Amendment to the Securities and Exchange Law* (Part II), CAMRI REV., June 1992, at 2 [hereinafter the Law or Financial System Reform Law]. The Financial System Reform Law is a comprehensive law that affects various aspects of the Japanese financial system — amending 15 other laws and

permits the mutual entry of banks and securities firms into each others' markets through subsidiaries. The Law therefore does not completely dismantle the Article 65 barrier, and firewalls will be implemented to keep banking and securities activities separate to a greater or lesser degree. Furthermore, the impact of the Law will be delayed over several years, with staggered entries for different types of financial market participants and with queues to be established by the MOF to prevent market "confusion." Thus, the Law will not trigger a "Big Bang" in liberalizing Japan's financial system.

Since the Occupation forces initially imposed the separation of securities and banking on Japan, it has been generally assumed that Japan would significantly modify Article 65 only after the United States had made similar amendments to Glass-Steagall.⁶ It is therefore ironic that Japan has lowered its Glass-Steagall barrier ahead of the United States. It is also ironic that the Law has been enacted at a time of serious reversals in the Japanese stock and real estate markets, on-going scandals in the securities markets, a growing nonperforming loan problem in the banking system, and a recession that appears more serious than previously anticipated. The business opportunities eagerly sought by securities and banking groups throughout the 1980s seem now far less appealing.

There are various reasons to study Japan's approach to the issue of banking and securities businesses, some of which are obvious while others are more subtle. First, Japan's status as the world's second largest economy and largest creditor nation ensures that any significant change in Japan's financial structure will have important implications for global finance and trade. At a minimum, Japan's action seems likely to intensify pressure in the United States to further reduce Glass-Steagall restrictions.

Second, in contrast to the United States and other western economies, a major characteristic of Japanese finance from its beginnings in 1868 has been the role played by negotiated, rather than market, transactions. Japan's financial structure has accordingly not relied on market-oriented transactions, open markets, financial disclosure, or a legal system that codifies permissible and impermissible activities to the same extent as many

abolishing one other.

6. See, e.g., ARON VINER, *INSIDE JAPANESE FINANCIAL MARKETS* 34 (1987). ("The Japanese side of the pair is immortal so long as its elder American brother survives. The death of the senior twin, however, will assure the demise of the junior.").

western financial systems. A shift by the Japanese banks towards more open and competitive transactions in the securities markets would be significant in light of the structure of the financial system of the early 1970s.

Third, Japan's rise to its position as the world's second largest economy, and its mushrooming current account surpluses, have attracted criticism of its financial transition process. The United States in particular has pressured Japan to increase its pace of liberalization, to increase foreign access to Japan's domestic financial markets, and to internationalize the yen. A shift towards more open securities markets would represent a major response to these criticisms.

Fourth, Japan's financial transition has been one of the least disruptive among the industrial countries of the world, at least through the end of the 1980s.⁷ Japan's macroeconomic record during the past two decades has been among the best in the world, despite oil price shocks, a shift to a floating exchange rate regime, a shift in the economy's underlying growth path, and ongoing financial transition. The collapse of the stock and real estate markets, beginning in late 1989, has marred this record, however, and the question may be asked whether the shift toward broader bank powers announced by the Financial System Reform Law is taking place at the most appropriate time.

This paper first presents a background on the banking system in Japan, tracing liberalization movements over the last twenty years. The paper then turns to a discussion of Article 65 and the impact of the Financial System Reform Law on that provision. The paper ends with some observations on Japan's approach to the Glass-Steagall issue, and a prognosis for future developments in Japan.

II. HISTORICAL DEVELOPMENT OF THE JAPANESE BANKING SYSTEM

Banking and finance in Japan have experienced three transitional stages over roughly the last century. These can be roughly divided into the periods from 1868 to World War II, from the end of the war to the 1970s, and from the 1970s to the

7. This is largely because the Bank of Japan has been permitted to pursue a price stabilization policy. See CARGILL & ROYAMA, *supra* note 1, at 166; Thomas F. Cargill & Michael M. Hutchison, *The Response of the Bank of Japan to Macroeconomic and Financial Change*, in *MONETARY POLICY IN PACIFIC BASIN COUNTRIES* 227, 235 (Hang-Sheng Cheng ed., 1988).

present.⁸ Following the Meiji Restoration in 1868, Japan first adopted a national policy of industrialization to achieve economic parity with the West. Banks, including various specialized financial institutions, were established to mobilize the country's financial resources in support of industrialization and economic growth. Since that time, banking and finance have been one and the same, with private non-bank financial institutions and direct securities markets playing only minor roles in Japan's financial development until recently.⁹

Six characteristics of this period may be noted. First, the industrial structure was dominated by the *zaibatsu* — large conglomerates owned and managed by wealthy families — in which banks played a secondary role. The *zaibatsu* banks however became powerful institutions; by 1914, the five largest banks controlled approximately twenty percent of the loans and deposits in the ordinary banking system, a figure that grew to about forty percent in 1935, while by 1930, sixty percent of savings deposits and seventy percent of trust assets were held by *zaibatsu*-controlled institutions.¹⁰ Second, financial panics in the 1920s led to steep reductions in the number of banks to permit better regulatory oversight, and this consolidation continued through the end of World War II; the number of banks in Japan dropped from 1,697 in 1905 to 424 in 1936, dropping still further for ordinary banks from 377 in 1937 to 61 by 1945.¹¹ Third, limits on competition were self-imposed by cartels and agreements among differ-

8. The second phase can alternatively be said to have ended in the 1920s when the government began greatly to expand its regulatory control over the financial system. Government control increased further under the military regimes of the 1930s, culminating with wartime controls over the entire financial system. This process did not terminate after the war, however, despite various Occupation reforms. Indeed, wartime financial controls formed the basis of the government's post-war regulatory controls over the economy. WILLIAM TSUTSUI, *BANKING POLICY IN JAPAN* 9-17, 124-25 (1988). For a chronology of regulatory actions in Japan from 1975 to 1991, see Thomas F. Cargill & Shoichi Royama, *The Evolution of Japanese Banking and Finance*, in *BANKING STRUCTURES OF MAJOR COUNTRIES* 333, 376-88, 591 (George G. Kaufman ed., 1992).

9. The first stock exchanges in Japan were established in 1878, but these markets were speculative, without a true capital market function. The *zaibatsu* system permitted financing of corporate enterprise within the *zaibatsu* groups, as the main banks provided both short-term working capital loans and long-term "frozen" loans that became a permanent part of the capital of the *zaibatsu* enterprises. FEDERATION OF BANKERS ASSOCIATIONS OF JAPAN, *BANKING SYSTEM IN JAPAN* 3 (1984); see generally TSUTSUI, *supra* note 8, at 5.

10. TSUTSUI, *supra* note 8, at 7, app. I at 127.

11. See Frances Rosenbluth, *The Political Economy of Financial Reform in Japan: The Banking Act of 1982*, 6 PAC. BASIN L.J. 62, 81-82 (1989).

ent *zaibatsu*, supported by explicit or tacit government approval.¹² Fourth, the financial system was internationally isolated. Fifth, financial transactions were generally made on a secured basis only.¹³ Sixth, financial transactions were negotiated, rather than market-oriented, so that borrower-lender relationships have been characterized by many more aspects than the quantity and the price of funds exchanged.¹⁴ Estimates indicate that indirectly negotiated transactions have played a far more important role in Japan than in the United States, and that banks have provided a more important conduit for transferring funds in Japan than in the United States.¹⁵

Japan experienced its high growth period from the end of the war to the early 1970s, when real output grew at annual rates of around ten percent. Despite various Occupation reforms, the banking and financial system of the post-war period continued trends firmly established in the 1930s, including a pattern of activist intervention in the financial system that was to be given a new focus after the war.¹⁶ A small number of banks dominated the flow of funds, domestic finance remained insulated from international forces, the financial system was designed to support industrialization and rapid growth, households were excluded from the financial system as fund users, financial transactions continued to be collateralized, and negotiated transactions dominated the financial system. Securities markets remained undeveloped for both private and public sector obligations, as the liquidity needs of the private sector were met by banks, and the small amounts of government debt that began to be issued after 1965 were absorbed by a captive syndicate of financial institu-

12. See, e.g., CHALMERS JOHNSON, *MITI AND THE JAPANESE MIRACLE* 109-12 (1982).

13. From the 1920s, especially after losses suffered in the financial panic of 1927, most financing in Japan has required collateralization, including corporate bond issues, bank lending, and interbank transactions. See *THE JAPANESE FINANCIAL SYSTEM* 43-44 (Yoshio Suzuki ed., 1990). Among other factors, this requirement has retarded the development of a corporate bond market. See discussion *infra* note 126.

14. This distinction is similar to that made by Professor Williamson between markets and hierarchies; however, it is not easily amenable to measurement. OLIVER E. WILLIAMSON, *MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS* (1975).

15. See CARGILL & ROYAMA, *supra* note 1, for a decomposition of the Japanese and U.S. flows of funds over the period from 1954 to 1985 in terms of a four-part taxonomy: indirect-negotiated, indirect-open market, direct-negotiated, and direct-open market (based on a study in SHOICHI ROYAMA, *FINANCIAL LIBERALIZATION* (1986)).

16. See Koichi Hamada & Akiyoshi Horiuchi, *The Political Economy of the Financial Market*, in *THE POLITICAL ECONOMY OF JAPAN, 1 THE DOMESTIC TRANSFORMATION* 223 (Kozo Yamamura & Yasukichi Yasuba eds., 1987).

tions and securities companies.¹⁷

Three discernable changes occurred however during the post-war period. Explicit regulatory powers introduced during the 1930s and wartime were refocused to impose a wide range of portfolio constraints on market participants to rebuild the economy. Virtually all interest rates were regulated, financial institutions were assigned specialized roles,¹⁸ and broad-based credit allocation controls were implemented. The MOF became the primary regulatory authority of Japan,¹⁹ followed by the Bank of Japan (BOJ) and the Ministry of Posts and Telecommunications was a distant third.²⁰ Regulation of the financial system was en-

17. The "Dodge Line" of fiscal policy during the Occupation required Japan to follow a strict policy of balanced budgets, despite the Ministry of Finance's (MOF) strong preference toward deficit financing to revitalize the economy. Government bonds were not issued until 1965, when limited deficit financing was first permitted at below-market cost to offset declining tax revenues through a captive government syndicate comprised primarily of banks. The Bank of Japan (BOJ) repurchased about 90% of each issue of bonds after one year in order to free up the banks' capital. KAZUO TATEWAKI, *BANKING AND FINANCE IN JAPAN* 27-28 (1991); *see also* Rosenbluth, *supra* note 11, at 68-69.

18. The Japanese post-war financial system is characterized by a high degree of specialization among different financial institutions. The principal Japanese banks are classified as city banks, regional banks, long-term credit banks, and trust banks. A variety of other specialized institutions exist for small business and for agricultural, forestry, and fishery groups. *See* *BANKING SYSTEM IN JAPAN*, *supra* note 9, at 28-39; *THE JAPANESE FINANCIAL SYSTEM*, *supra* note 13, at 163-70; TATEWAKI, *supra* note 17, at 99.

19. The MOF regulates substantially all private and public financial institutions in Japan, combining the functions of the United States Treasury, Office of Management and Budget, Internal Revenue Service, Securities and Exchange Commission, Comptroller of the Currency, and all of the state banking and insurance regulators, as well as the supervisory functions of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Office of Thrift Supervision. MAUREEN LEBLANC & ANDREW C. SVARRE, *FEDERAL RESERVE BANK OF NEW YORK, THE JAPANESE FINANCIAL SYSTEM* 2 (1988). In addition it administers the gigantic Trust Fund Bureau (comprised primarily of postal savings and welfare and national pension funds) and appoints the heads of specialized government financial institutions as well as the managing directors, advisors, and auditors of the BOJ. Securities activities are supervised through the MOF's Securities Bureau, while banking is supervised through the Banking Bureau. *See, e.g.*, TATEWAKI, *supra* note 17, at 143-45, 175-78. Not all financial institutions are regulated fully by the MOF, however. The Ministry of International Trade and Industry (MITI) has jurisdiction over leasing and installment credit companies, the Ministry of Agriculture shares oversight responsibilities for the agricultural co-operatives in Japan, including the Norinchin Bank, and the Ministry of Construction oversees securitized interests in real estate (which are not considered "securities" for purposes of Japanese law).

20. The BOJ regulates the money supply and maintains orderly credit conditions in the financial system. *See, e.g.*, *THE JAPANESE FINANCIAL SYSTEM*, *supra* note 13, at 305. The Ministry of Posts and Telecommunications is the repository for the vast Postal Savings System, in which fixed amount savings in March 1989 stood at ¥125.9 trillion, about the same as all personal deposit balances in the private banking system. TATEWAKI, *supra* note 17, at 142. The overall regulatory structures of Japan and the United States are compared in THOMAS F. CARGILL, *CENTRAL BANK INDEPENDENCE AND REGULATORY RE-*

forced through a mixture of formal written regulations and informal, unwritten administrative guidance.²¹ Such regulation led to a highly controlled flow of funds from the household sector to the funds-poor corporate sector: city banks and regional banks offered short-term deposits and loans to large corporations and to smaller businesses, respectively, while long-term credit banks and trust banks took long-term deposits and made long-term loans.²²

The second significant change in the post-war period was that city banks (and some larger regional banks) shifted from their secondary role in the pre-war *zaibatsu* to a leadership role in the post-war *keiretsu* — the headless corporate groups that characterize Japanese business today. The emergence of banks as leaders within the *keiretsu* is reflected in the phrase, "main bank system," which describes Japanese corporations' dependence on their main bank for both long- and short-term financing.²³

The third change in the post-war period was the Occupation's effort to change the structure of Japanese finance. The

SPONSIBILITY: THE BANK OF JAPAN AND THE FEDERAL RESERVE (1989).

21. "Administrative guidance" (*gyōsei shidō*) refers to the Japanese government's practice of issuing directives, requests, etc., to regulated parties within such ministries' jurisdiction and to obtain such parties' compliance with administrative objectives, whether or not based on specific statutory authority. See, e.g., Yoriatzi Narita, *Gyōsei Shidō [Administrative Guidance]*, translated in 2 LAW IN JAPAN 45 (1968); JOHNSON, *supra* note 12, at 265. Technically non-binding, and often oral, administrative guidance gives the regulatory authorities significant flexibility to mold regulations to changing circumstances and to develop ad hoc solutions as problems arise, without giving particular concern for the precedential implications of the action. Administrative guidance, in the sense of extra-legal administrative cajoling or encouragement, is not unique to Japan, for in the United States as well, government bureaucracies jawbone, advise, withhold permissions, etc., in order to obtain desired objectives. However, the pervasiveness of administrative guidance in Japan, and the widespread acceptance by those affected by it, distinguish it from comparable administrative action in the United States.

22. Foreign banks played a minor role, being restricted primarily to providing "impact" or foreign currency loans not authorized to the Japanese banks. CARGILL & ROYAMA, *supra* note 1, at 20-57, presents a detailed set of flow of funds accounts for Japan over the period from 1954 to 1985.

23. See C.D. Elston, *The Financing of Japanese Industry*, BANK OF ENGLAND Q. BULL. 510-18 (Dec. 1981). See also CARGILL & ROYAMA, *supra* note 1, at 46. This dependence is one of the primary concerns raised by the securities industry over expanded bank securities powers, since bank control over *keiretsu* borrowers creates a captive market for securities services to be offered by banks or their subsidiaries. SECURITIES AND EXCHANGE COUNCIL, HOW BASIC SYSTEMS REGARDING CAPITAL MARKET OUGHT TO BE REFORMED 18 (Capital Markets Res. Inst. trans., 1991) [hereinafter SECURITIES AND EXCHANGE COUNCIL FINAL REPORT]; SHŌKEN DANTAI KYŌGIKAI, KINYŪ SEIDŌ KAIKAKU RONGI NO MONDAI TEN 24-25 (1989).

Occupation's principal reform was to dissolve the *zaibatsu*, in an effort to democratize post-war Japan and to make its industrial structure more competitive.²⁴ The dissolutions, however, fell short of their original target.²⁵ While they eliminated family control of the *zaibatsu*, company groups soon re-emerged in the form of *keiretsu*, often centered around a pre-war "main bank."²⁶ The Occupation's second financial reform was the adoption of Article 65.²⁷ In other respects, however, while the Occupation initially sought broad reform of the financial system, the banking system was ultimately left relatively untouched by the Occupation.²⁸

The third stage of Japan's financial development dates from the 1970s, when a variety of forces converged to drive Japan's financial system toward a more flexible, open, and internationalized structure. The principal agent of change in the Japanese financial system was the combined effect of the "oil shock" of 1973-74 and the vast increase in government debt financing that followed. The oil shock disrupted Japan's financial development, causing a downward shift in the underlying growth path and a resulting change in the flow of funds within Japan. It also triggered a doubling of the central government and overall public

24. See T.F.M. ADAMS & IWAO HOSHII, *A FINANCIAL HISTORY OF THE NEW JAPAN* 23-25 (1972).

25. In 1946, the Edwards State-War Mission on Japanese Combines called for the severing of all ownership, personnel, and contractual and financial ties *within* the *zaibatsu*, and the deconcentration of the largest companies into smaller units which would not constitute a material or potential threat to competitive enterprise. TSUTSUI, *supra* note 8, at 42-43. Instead, only a more limited dissolution, suggested voluntarily by the Yasuda *zaibatsu* itself, was followed. Only the holding company was liquidated and its stockholdings transferred to a liquidation commission for ultimate distribution to the public, without severing relationships among those companies or breaking up large companies into smaller components. TSUTSUI, *supra* note 8, at 41-46.

26. Of the seven largest banks in Japan, six are direct successors to *zaibatsu* banks, and their *keiretsu* groups continue to dominate Japan's industrial structure. See, e.g., Marie Anchordoguy, *A Brief History of Japan's Keiretsu*, 6 HARV. BUS. REV. 58-59 (July-Aug. 1990); Maruyama Yoshinari, *The Big Six Horizontal Keiretsu*, 39 JAPAN Q. 186, 188 (1992).

27. Occupation forces also attempted to restructure the BOJ along the lines of the Federal Reserve System's Board of Governors, which proved a futile exercise. TSUTSUI, *supra* note 8, at 78, 85-89.

28. While Antitrust and Cartels Division of Economic and Scientific Section of the Supreme Commander for the Allied Powers (SCAP) urged overhaul of the banking system, Finance Division feared that tinkering with the nation's banks would invite financial disaster. The Finance Division, with the backing of Washington as the "reverse course" took hold, and eventually won out. TSUTSUI, *supra* note 8, at 56-59.

sector deficits,²⁹ which proved increasingly difficult for the MOF to fund — especially since the financial system operated without open money and capital markets. The MOF was forced, therefore, to rely ever more heavily on the banks to fund purchases of mushrooming government debt. When the BOJ signalled that it would no longer assure guaranteed repurchases of such debt one year from issuance at original purchase cost, the banks resisted MOF's efforts to place the government debt with them unless they received financial liberalizations in return.³⁰

Liberalizations were demanded by different groups, each with its own interests. The banks sought liberalization because they had lost market share in the total flow of funds since the decline in the corporate sector deficit reduced that sector's dependence on bank credit. Securities companies sought liberalization because the development of open money and capital markets, and the internationalization of finance, offered new opportunities to expand their role in the financial system. The corporate sector became an advocate for liberalization because it experienced an increase in liquidity after 1973 as a result of a slower rate of investment. Corporations became less dependent on the banking system and found that they could get by without maintaining the large compensating balances typically required by banks during the high-growth period. Thus, the corporate sector saw liberalization as a way to enhance profits and diversify into financial asset management. The household sector became an advocate for liberalization because high rates of real income growth no longer compensated for the limited set of financial assets available at regulated rates of return.

Spurred on by two other catalysts for financial reform — the abandonment of fixed exchange rates after 1973 and pressures by the United States for reform in the early 1980s³¹ — Japan has carried out regulatory reforms that have fundamen-

29. The corporate sector deficit decreased by 50% during this period. In Japan's high growth period, the central government sector generally operated with a small surplus, although combined with other public sector deficits, the overall public sector was a deficit sector approximately equal to one-third the size of the corporate sector deficit. See CARGILL & ROYAMA, *supra* note 1.

30. See CARGILL & ROYAMA, *supra* note 1, at 117; ROBERT A. FELDMAN, JAPANESE FINANCIAL MARKETS: DEFICITS, DILEMMAS, AND DEREGULATION 50-51 (1986); Rosenbluth, *supra* note 11, at 68-75.

31. The worsening trade deficit with Japan prompted the United States to seek to "internationalize" the yen, to increase foreign financial institution access to Japan's markets, and to increase the pace of Japanese domestic liberalizations generally.

tally altered its financial structure. Loan rates have been deregulated for over a decade, and large deposits (over about \$20,000) have been unregulated, with liberalization of small deposits scheduled for 1993. Primary and secondary money and capital markets have expanded greatly, and corporations have relied more on capital markets than in the past, although most of the growth in the bond market is attributable to government deficit financing rather than the corporate sector. Interest rates in money and capital markets are market determined, and there is a close relationship between domestic money market rates (such as the *gensaki* rate on government bond repurchase agreements) and international rates. Japan has made significant progress toward unrestricted capital inflows and outflows. The value of the yen is market determined, and the yen has gradually become a more desirable reserve and investment asset. Foreign participation in Japan's financial system has increased significantly in the past decade, as has Japanese banking presence in other countries, and Japan's financial system has become an important component of the international financial environment. These changes, however, have still done little to encourage corporate bond markets or to eliminate binding barriers between different financial institutions and between direct and indirect markets.

III. THE SEPARATION OF BANKING AND SECURITIES ACTIVITIES IN JAPAN: ARTICLE 65 AND THE FINANCIAL SYSTEM REFORM LAW OF 1992

A. Article 65³²

Article 65 of the Japanese Securities and Exchange Law ex-

32. Securities and Exchange Law, Law No. 25 of 1948 (amended), art. 65 (Capital Markets Research Inst. trans., 1988). [hereinafter SEL]. SEL, art. 2, ¶ 8 defines securities business as "the business conducted by any person other than banks, trust companies or such other financial institutions as may be designated by a Cabinet Order to engage in any business below specified" (reflecting exceptions for various options and futures products):

- (1) to buy and sell securities or trade in futures of securities index, etc., securities options, or securities futures of foreign markets,
- (2) to act as broker, agent or proxy with respect to buying and selling of securities or trading in securities options or securities futures of foreign markets,
- (3) to act as broker, agent or proxy with respect to orders for trades below specified:
 - a) buying or selling of securities, or trading in futures of securities index, etc., or securities options, or
 - b) buying or selling of securities, or trading in securities futures of for-

cludes banks and other financial institutions from engaging in "securities business," including dealing, underwriting, and brokerage of securities other than government and public entity bonds, and related derivative securities.³³ Together with Article 43 of the Securities and Exchange Law, which prohibits securities companies from engaging business other than securities business without MOF approval, and Article 10 of the Banking Law, which restricts banks from engaging in any businesses other than banking and businesses auxiliary to banking,³⁴ Article 65 creates a division between securities and banking business similar to that created by Glass-Steagall.

eign markets on foreign securities markets . . .

(4) to underwrite securities,

(5) to sell securities through public offering, or

(6) to handle the issuance or sale of securities through public offering.

Licenses to conduct securities business may be granted under any of four headings: dealer business, broker business, underwriting business and selling business, i.e., handling the issuance or sale of securities in public offerings without underwriting the securities involved. SEL, art. 28, ¶ 2.

33. SEL, *supra* note 32. Article 65 provides that:

No bank, trust company and such other financial institutions as may be prescribed by an ordinance of the Ministry of Finance shall do as its business any of the acts set forth in the items of Paragraph 8 of Article 2 [i.e., securities business, as defined]; Provided, That this shall not apply to cases where any bank buys or sells securities or effects securities index futures trading, securities options trading or foreign market's securities futures trading pursuant to a written order received from its customer for the account of such customer or where any bank, trust company or such other financial institutions as may be prescribed by a Cabinet Order buys or sells securities or effects securities index futures trading, securities options trading or foreign market's securities futures trading for the purpose of investment or pursuant to a trust agreement signed with its customers and for the account of such customers in accordance with the provisions of other laws.

SEL, *supra* note 32.

Paragraph 2 of Article 65 exempts from the scope of its prohibition banks' underwriting, dealing and other securities activities (other than brokerage) in national and local government securities (including government-guaranteed securities), and dealing and brokerage activity in futures and options products relating to government securities.

34. Banking Law, Law No. 59 of 1981, *translated in* 6 LAW BULL. SERIES (EHS), BA1, 5-6 (1987). Article 10 of the Banking Law provides that banks may engage in (i) accepting deposits, (ii) lending funds or discounting bills, drafts or notes, and (iii) effecting transactions in exchange and money orders. Article 10-2 of the Banking Law permits banks to engage in certain specifically enumerated activities, such as acting as surety, buying securities for investment or the account of customers, etc. and other businesses "incidental" to the banking business. Article 12 of the Banking Law restricts banks from engaging in businesses other than as permitted by Articles 10 and 11, the Secured Bond Trust Law, and other laws. Insurance companies are similarly restricted to the insurance business by Article 5 of the Insurance Business Law, Law No. 41 of 1939, *translated in* 6 LAW BULL. SERIES, (EHS), FA1, 2 (1984).

While the policy basis for Glass-Steagall is prudential — to protect depositors' assets against the risks believed to be inherent in bank securities ownership and trading activities — the original policy basis for Article 65 appears to have been as much political as prudential — to restrain Japanese banks from exerting hegemony over the financial system as a whole, and as a corollary, to help develop independent securities markets. Whatever the original policy purposes, however, they were purposes of the Occupation, not the Japanese legislature, and in this sense Article 65 fulfills no domestic policy purpose at all. By its endurance, however, Article 65 has become an accepted feature of the Japanese financial system, and, by conferring on the MOF another means of maintaining the segmented and specialized financial system of post-war Japan it has come to serve a quite different policy purpose than that originally intended. These differences in policy basis, as well as cultural and historical factors, are reflected in the various differences between Article 65 and Glass-Steagall.

1. Purposes of Article 65

Article 65 was proposed by Occupation authorities for the first time in mid-1947, after the Diet had already passed a United States-modeled Securities and Exchange Law,³⁵ and was approved as part of the completely revised Securities and Exchange Law of 1948.³⁶ As explained by General Headquarters for the Supreme Commander of Allied Powers (SCAP) in its official statement, Article 65 was intended to protect depositors from banks' securities activities, since underwriting of securities was inherently a dangerous business for trust institutions.³⁷ Given the Occupation authorities' general belief that what was good for America was also good for Japan, this may be all that Article 65 was intended to achieve.³⁸ But this seems doubtful. Given Ja-

35. YASUJI ABE, *GINKŌ SHŌKEN KAKINE RONSŌ OBOEGAKI* 31, 58 (1980). The only provision of the 1947 law to enter into force was that which created an independent securities and exchange commission based on the U.S. model. *Id.*

36. ADAMS & HOSHII, *supra* note 24, at 52. Both Yasuji Abe, then a director of Yamaichi Securities, and T.F.M. Adams mention the personal role that the new chief of the Securities Section played in developing the provision. Abe identifies the new section chief as Adams (no first name given), although Adams refers only to "the official in SCAP in charge of the matter." ABE, *supra* note 35, at 58-59; ADAMS & HOSHII, *supra* note 24, at 52.

37. THE JAPANESE FINANCIAL SYSTEM, *supra* note 13, at 39.

38. See, e.g., TSUTSUI, *supra* note 8, at 121, 123 (Occupation reform proposals in

pan's undeveloped securities markets at that time, the actual risk of harm to depositors through bank securities activity would have been virtually nonexistent, and Article 65's prudential purpose would have been meaningless.

Article 65's more basic purpose seems to have been to restrict bank activity over non bank sectors of the financial system³⁹ and so to encourage the development of an independent long-term financial market, which the Occupation planners strongly favored.⁴⁰ Article 65 may also have served a tactical purpose in the struggle within SCAP at the time it was adopted over the issue of bank deconcentration. The Finance Division, deeply concerned about the impact of such deconcentrations on the financial system, strongly opposed proposals by the Anti-trust Division to break up Japan's larger banks into regional units.⁴¹ It instead proposed less radical reforms to destroy "monopolistic positions" by the banks, including prohibitions against bank affiliations with securities firms,⁴² and Article 65 was such a measure. The surprisingly muted response of the Japanese banks to Article 65 suggests that they understood it as an alternative to deconcentration, and by far the lesser of two evils.⁴³ The Finance Division's lobbying efforts against bank

finance were directed only to superficial institutional changes, based on an ethnocentric vision of an "Americanized" Japan).

39. Tsutsui, *supra* note 8, at 68-69 (Finance Division of SCAP sought to increase competition within the existing banking system, "primarily by promoting non-zaibatsu institutions to challenge the financial superiority of the largest banks"); Rosenbluth, *supra* note 11, at 67 (banks' grip on finance seen by Occupation authorities as anti-competitive, to the detriment of both corporations and depositors).

40. See ADAMS & HOSHII, *supra* note 24, at 52 (by disassociating underwriting from banking, and making it the exclusive province of securities companies, "the basic distinction between long- and short-term financing was institutionalized"); Tsutsui, *supra* note 8, at 102-03, 107 n.66 (hopes of Joseph Dodge, United States financial emissary to Japan and architect of the "Dodge Line," for independent securities markets for long-term capital).

41. In 1947, the Antitrust Division proposed the break-up of Yasuda Bank into three regional banks, and in early 1948 supported a much broader proposal to divide all national banks into small units, each to operate within a single region, of which there would be three to eight — an attempt in effect to replicate the local bank system of the United States, which Antitrust Division believed would tend to promote democratic values and prevent the resurgence of a militaristic financial complex. Tsutsui, *supra* note 8, at 53, 57.

42. Tsutsui, *supra* note 8, at 76, 80 (citing Finance Division memo dated March 8, 1948). Such prohibitions against bank affiliation with securities firms were never adopted.

43. ABE, *supra* note 35, at 58-59; Tsutsui, *supra* note 8, at 33. The bank most closely connected with securities underwriting, the government-owned Industrial Bank of Japan, was particularly silent; it may have been aware that the Occupation intended not

deconcentration were successful. While large banks were initially to have been broken up under the Corporation Deconcentration Act of December 1947, banks were exempted from the law in July 1948.⁴⁴ This view of Article 65 is also shared by Japanese securities law scholars, who tend to interpret it primarily as a restriction on bank influence on the economy, and so to promote securities markets, with protection of depositors only an ancillary purpose.⁴⁵

Whatever its original purpose, Article 65 has proved a useful regulatory device to the MOF in promoting the segmented and specialized financial system characteristic of post-war Japan.⁴⁶ The "Big Four" securities firms, which grew up under the shelter of Article 65, agreed to MOF control over the securities

only to break it up, but to disband it entirely. ABE, *supra* note 35, at 59; TSUTSUI, *supra* note 8, at 33. Acceptance of Article 65, while an important restriction, was a feasible alternative for the banks since their securities activities had in practice been limited to underwriting. In this sense, Article 65 reflected an informal division between banking and securities activities that had existed before the war. THE JAPANESE FINANCIAL SYSTEM, *supra* note 13, at 39.

44. Rosenbluth, *supra* note 11, at 83.

45. KATSURŌ KANZAKI, SHŌKEN TORIHIKI HŌ (SHIMPAN) 401 (1987) (purposes of Article 65 are to prevent excessive bank control over the economy, while at the same time protecting depositors' assets); T. SUZUKI & I. KAWAMOTO, SHŌKEN TORIHIKI HŌ (SHIMPAN) 261 (1984) (primary purpose is to provide foundation for full development of securities industry; ancillary purpose of depositor protection is evidenced by failure of Article 65 to restrict bank ownership of securities); Katsurō Kanzaki, *Shōken Gyōmu to Ginkō Gyōmu in K. KANZAKI & M. TATSUTA, SHŌKEN TORIHIKI HŌ TAISEI* 389 (1986) (noting both purposes); Tatsuta, *Kinyū Seidō Kaikaku to Kyōsō Seisaku: Ginkō no Sannyū to Shōken Shijō*, 74 SHIHON SHIJŌ 5, 7-8 (1991) (a major purpose is to prevent the danger of a vicious cycle of feebly functioning capital market functions and increasing dependence on bank finance by nurturing active capital markets); SECURITIES AND EXCHANGE COUNCIL FINAL REPORT, *supra* note 23, at 18 (basic principles underlying Article 65 are the prevention of conflict of interest, avoidance of banks' dominating the market and exercising influence over companies, and securing of sound bank management). The protective purpose of Article 65 is emphasized, naturally, by the securities industry and not the banking industry, which cites only the purposes of avoiding conflicts of interest and threats to sound bank management. FINANCIAL SYSTEM RESEARCH COUNCIL FINAL REPORT ON A NEW JAPANESE FINANCIAL SYSTEM 26 (Federation of Bankers Ass'n of Japan Trans., 1991) [hereinafter FINANCIAL SYSTEM RESEARCH COUNCIL FINAL REPORT].

46. This is in sharp contrast to the Antimonopoly Law, which from the outset was totally inconsistent with the policies of the MITI to develop orderly exports and to avoid excessive internal competition in rebuilding the nation's infrastructure. Given Japan's long history of government-sanctioned or government-required cartels, hardly any law could have been less attuned to Japan's economic traditions, and the law began to be amended almost immediately upon its enactment. See Yoshio Kanazawa, *The Regulation of Corporate Enterprise: The Law of Unfair Competition and the Control of Monopoly Power*, in LAW IN JAPAN: THE LEGAL ORDER IN A CHANGING SOCIETY 480, 484-90 (Arthur T. von Mehren ed., 1962); see generally ELEANOR M. HADLEY, ANTITRUST IN JAPAN (1970).

markets in return for MOF's protection against incursion by the banks and MOF's assurance of continued high, fixed brokerage commissions. Meanwhile, the MOF has been able to use concessions on the scope of Article 65-permitted activities as a bargaining chip in dealing with the banks,⁴⁷ while Article 65's Occupation pedigree has permitted it to withstand political pressure from the banks as long as Glass-Steagall held up in the United States.⁴⁸ Altogether, the MOF has been able to adopt Article 65 to policy purposes of its own, which may explain its endurance.

2. Article 65 and Glass-Steagall

There are several significant differences between Article 65 and Glass-Steagall, and these differences have generally permitted banks in Japan greater latitude in securities activities than banks in the United States. While United States Glass-Steagall distinctions have generally been made on the basis of activities — with underwriting most strongly prohibited, while brokerage is not — distinctions in Japan have tended to be drawn along product lines, with considerable bank involvement with debt securities and minimal bank involvement with equity securities, other than equity ownership.

A fundamental difference is that Article 65 permits Japanese banks to purchase, sell, and own securities for their own investment purposes,⁴⁹ while Glass-Steagall restricts banks' securities purchases for their own account to limited types and amounts of debt securities, thus preventing bank ownership of equity securities altogether.⁵⁰ The only restriction on Japanese

47. In the bank discussions underlying the revision to Article 65 in 1981, the MOF sought to offer expanded bank powers to underwrite and sell government bonds as a bargaining chip to obtain greater reporting compliance from the banks. That effort, however, failed. See Rosenbluth, *supra* note 11.

48. See Rosenbluth, *supra* note 11, at 67.

49. Article 65 provides in relevant part that no bank, trust company or other designated financial institution may engage in securities business, "[p]rovided, that this shall not apply to cases where any bank . . . buys or sells securities or effects securities index futures trading, securities options trading or foreign market's securities futures trading for the purpose of investment" (emphasis added).

50. Section 16 of Glass-Steagall permits a bank to "purchase for its own account investment securities under such limitations and restrictions as the Comptroller of the Currency may by regulation prescribe," 12 U.S.C. § 24 (Supp. 1991) (emphasis added), but equity securities are not included in the Comptroller's definitions of "investment security," 12 C.F.R. § 1.3 (1992). This is a difference in regulatory interpretation of what constitutes "investment securities," since both statutes permit purchases of investment securities for banks' own accounts.

bank securities ownership is provided by the Antimonopoly Law, which prevents banks from purchasing more than five percent of a company's stock without prior approval of the Fair Trade Commission.⁵¹ Accordingly, Japanese banks may have, and do have, large securities portfolios with five-percent-or-less stakes in many Japanese corporations.⁵² Therefore, Article 65, as interpreted, attributes to bank ownership of securities a far lower risk to bank depositors than does Glass-Steagall. In fact, some Japanese securities scholars conclude that this difference itself demonstrates that protection of bank depositors is only an ancillary purpose of Article 65, while its main purpose is to encourage the development of securities markets through the protection of securities firms.⁵³

Second, Article 65 does not restrict Japanese banks from affiliating with securities firms, and in fact through a combination of five-percent-or-less shareholdings with other contractual arrangements, all major Japanese banks have close affiliations with securities firms.⁵⁴ Glass-Steagall, in contrast, on its face prohib-

51. Law Relating to Prohibition of Private Monopoly and Methods of Preserving Fair Trade, Law No. 54 of 1947, art. 11, para. 1 (as amended), *reprinted in* Law Relating to Prohibition of Private Monopoly and Methods of Preserving Fair Trade of Japan, 2 LAW BULL. SERIES JAPAN (EHS) KA1, 15 (1987) [hereinafter Antimonopoly Law]. The limit applicable to insurance companies is 10%. The Fair Trade Commission generally limits its exemptions to the 5% limit to cases where a bank seeks to engage, through a subsidiary, in an approved business related to banking, and where the subsidiary will act as agent of the parent bank or perform services related to the bank's core business for the benefit of the bank itself (managing back-office services, employee facilities, commercial property owned by the bank, etc.). Ichiro Kawamoto, *Legal Problems Involved in the Report of the Fundamental Research Committee of the Securities and Exchange Council*, CAMRI REV., Aug. 31, 1992, at 10, 15. Activities such as management consulting, leasing, venture capital business, mortgage lending, and dealing in mortgage-backed certificates, credit cards, factored receivables, etc., have been restricted to the 5% limit as well. *Id.*

52. As of 1989, one of the top three shareholders in all 1,888 companies listed on the Tokyo Stock Exchange was a bank, and banks collectively owned 20.5% of all issued and outstanding shares of all such listed companies. SHÖKEN DANTAI KYÖGIKAI, KINYŪ SEIDŌ KAIAKU RONGI NO MONDAI TEN 25 (1989).

53. See, e.g., SUZUKI & KAWAMOTO, *supra* note 45, at 261. United States law also strictly restricts the ownership of bank securities by commercial companies, while no such restriction applies in Japan. Bank Holding Company Act of 1956, 12 U.S.C. §§ 1841-1850 (1988).

54. Banks participate in the management of these firms, appointing top officers of the securities firms from among the bank's officers, transferring their own employees to securities firms for training, directing brokerage orders through such firms or extending securities services to bank clients. Mitsubishi Bank, Dai-Ichi Kangyō Bank and Sumitomo Bank, for example, have affiliate relationships with second-tier firms Ryoko Securities, NKK, and Meiko Securities, respectively, while The Industrial Bank of Japan is affiliated with New Japan Securities, Wako Securities and Okasan Securities. See, e.g.,

its any affiliation between banks and organizations "engaged principally" in the underwriting or distribution of securities, although the impact of this restriction has been reduced in recent years.⁵⁵ Since Glass-Steagall restricts affiliations with underwriters and distributors of securities, United States banks are permitted to engage in brokerage activities in any type of security, either directly or through subsidiaries.⁵⁶ In Japan on the other hand equity brokerage is considered the most sensitive of securities activities proscribed by Article 65.

Third, under the Japanese Securities and Exchange Law, the term "securities" is narrowly defined by reference to a specific list of bonds, stock shares, and various trust certificates.⁵⁷ This means that products similar to "securities," but not literally defined as such, may not be traded as securities or handled by securities firms without special permission from the MOF. By contrast, if such products are not classified as "securities," they

VINER, *supra* note 6, at 34-38.

55. 12 U.S.C. §§ 377, 378 (1988). The Federal Reserve Board currently considers that an affiliate is not "principally engaged" in securities activities as long as less than 10% of its revenues are generated by prohibited securities activities. At the same time, the Federal Reserve Board permits Glass-Steagall permissible securities activities (such as government bond trading) to be counted as permissible activities (against which the 10% of revenues may be measured) without considering the affiliate as being "principally engaged" in securities activities. The biggest U.S. banks are, therefore, able to generate sizeable revenues in otherwise prohibited areas such as equity underwriting through affiliated entities.

56. Retail brokerage activities of banks acting on behalf of customers have traditionally been permitted on a limited basis, and have been reaffirmed as permissible activities for bank subsidiaries without triggering the "affiliation" prohibitions of section 20. *Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys.*, 468 U.S. 207 (1984) (upholding acquisition of discount broker Charles Schwab & Co. by BankAmerica Corporation).

57. SEL, *supra* note 32, art. 2, defines securities as:

(1) Government securities, (2) municipal bonds, (3) debt securities issued under special enabling laws by juridical persons, (4) secured corporate bonds or unsecured corporate debenture bonds, (5) equity investment certificates issued by juridical persons under special enabling laws, (6) share certificates . . . or certificates representing the right to subscribe to new shares, (7) beneficiary certificates of securities investment trusts or loan trusts, (8) securities or certificates issued by foreign countries or foreign juridical persons which are of the same nature as the securities or certificates referred to in the foregoing items, and (9) such other securities or certificates as may be prescribed by a Cabinet Order.

SEL, Law No. 25 of 1948, art. 2 (Capital Markets Res. Inst. trans. 1988). Although item (9) would leave open room for an expansive definition of "securities," no new securities have been identified under this provision. Hideki Kanda, *Politics, Formalism, and the Elusive Goal of Investor Protection: Regulation of Structured Investment Funds in Japan*, 12 U. PA. J. INT'L BUS. L. 569, 573 (1992).

may be dealt in without constituting securities business for purposes of Article 65 and so may be handled by banks.⁵⁸ This categorization has permitted Japanese banks, through successful lobbying efforts with the MOF, to deal in a number of products, such as commercial paper and various securitized products, on the basis that they are not "securities" for Japanese law purposes, even though they would be in the United States.⁵⁹ This categorization has also permitted the MOF to exert regulatory authority over the securities and banking industries by permitting (or not permitting) certain products to be handled by each of them. In the United States, by contrast, the Supreme Court has construed "securities" to be "sufficiently broad to encompass virtually any investment that might be sold as an investment,"⁶⁰ either because the product in question constitutes in substance an investment contract,⁶¹ or because such product bears a sufficiently strong "family resemblance" to securities specifically enumerated in the Securities Act of 1933.⁶²

Fourth, while Article 65 parallels Glass-Steagall in permitting banks to underwrite and deal in government bonds and public entity bonds,⁶³ the fact that government bonds occupy

58. Securities firms must obtain the permission of the MOF to be engaged in any business other than the "securities business," which includes handling any products other than "securities." SEL, *supra* note 32, art. 43.

59. Commercial paper was classified in 1987 as a promissory note, and not a "security," allowing both banks and securities firms (with permission from the Minister of Finance) to handle the product. Before this, the banking industry had stonewalled the introduction of a commercial paper market in Japan for several years. See David G. Litt, et al., *Politics, Bureaucracies, and Financial Markets: Bank Entry Into Commercial Paper Underwriting in the United States and Japan*, 139 U. PA. L. REV. 369, 419 (1990). The banking industry also succeeded in avoiding "securities" classification for residential mortgage trust certificates and securitized bank loans, and, in addition, were able to block the securities industry from obtaining permission to deal in them. See Kanda, *supra* note 57, at 575.

60. *Reeves v. Ernst & Young*, 494 U.S. 56, 60 (1990).

61. *SEC v. W.J. Howey*, 328 U.S. 293, 296 (1946).

62. *Reeves*, 494 U.S. at 56. This does not mean that regulatory authorities in the United States have not sought to encourage their own regulated parties from engaging in new activities on the basis of product classification, since the Federal Reserve Board initially took the position in *Bankers Trust* that commercial paper was not a "security" and could be handled by Bankers Trust on that basis. *Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys. (Bankers Trust I)*, 468 U.S. 137 (1984).

63. Administrative guidance limited the banks' underwriting of such securities to national government securities during the high growth period, THE JAPANESE FINANCIAL SYSTEM, *supra* note 13, at 39, but beginning in the late 1970s the banks fought for expanded roles in underwriting, dealing and retail selling of government and other public entity bonds. Retail sales and dealing in government bonds were permitted by amendments to Article 65 enacted in 1981, while sales and dealing in index futures, options and

the overwhelming portion of the total bond market in Japan means that Japanese banks are more important players in the Japanese bond market than United States banks have been here.⁶⁴ In addition, for such relatively limited corporate bond financings as there are, the long-term credit banks and leading city banks act as commissioned companies, or quasi-trustees, for corporate bond issuers, and are involved in bond syndicates which set the offering timetables for such issues.⁶⁵ Japanese banks under Article 65 have also been able to act as agents in private placements of securities,⁶⁶ and to conduct securities activities outside Japan (through subsidiaries), although the MOF has restricted such activities through administrative guidance.⁶⁷

foreign market securities futures trading were permitted by amendments in 1985. See Rosenbluth, *supra* note 11, at 68.

64. In 1988 government bond trading accounted for approximately 90% of all bond trading in Japan. By contrast, in 1986 corporate bond issuances (excluding Nippon Telephone and Telegraph, a quasi-governmental issuer) accounted for only 0.5% of all domestic bonds issued. TATEWAKI, *supra* note 17, at 83, 86-87. As recently as March 1992, only 57 of Japan's 2,500 publicly listed companies had any domestic corporate bonds outstanding, while in the U.S., regular corporate bonds account for 31% of U.S. corporate debt. Quentin Hardy, *Japanese Companies Need to Raise Cash, But First a Bond Market Must Be Built*, WALL ST. J., Oct. 20, 1992, at C1. Banks are heavily involved in the government bond markets. As of June, 1990, 680 banks and other non-securities firms (including 39 insurance companies) had licenses to make retail sales of public bonds, 219 banks and other firms had dealing licenses, and 83 banks and other firms had commissions brokerage (*toritsugi*) licenses for futures transactions. Tatsuta, *supra* note 45, at 5, 7 n.2.

65. As a commissioned company (*jutaku gaisha*), the bank acts as a sort of financial advisor to the bond issuer while undertaking certain statutory and contractual obligations as a trustee on behalf of the bondholders. Osamu Kamihara, *Recent Developments in the Securities and Exchange Law of Japan*, in JAPANESE BANKING, SECURITIES AND ANTI-MONOPOLY LAW (Hiroshi Oda & R. Geoffrey Grice eds., 1988). Article 45 of the Securities and Exchange Law prevents securities companies from undertaking such roles for publicly offered issues.

66. The private placement market in Japan has grown from 166 offerings (¥39.1 billion) in fiscal 1985 to 734 offerings (¥417.7 billion) in the first nine months of fiscal year 1991, or ¥557 billion on an annualized basis. The attraction for the banks is the variety of fees they may charge (arrangers' fees, placement agents' fees, registration agents' fees, payment agents' fees, etc.), up to 10% of the issue offering prices. SHŌKEN DANTAI KYŪGIKAI, SEIDŌ KAIKAKU RONGI E NO GIMON 27-28 (1991). Private placement activities for U.S. banks were validated by *Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys.*, 807 F.2d 1052 (D.C. Cir. 1986) (validating bank private placement activities on an agency basis, so long as no prohibited underwriting activities are implicated).

67. The "three bureaus guidance" (*sankyoku shidō*) among the Banking, Securities and International Finance Bureaus of the MOF has restricted the ability of Japanese banks to establish overseas subsidiaries and to act as lead managers in securities offerings in the Euromarkets. Masabumi Yamane, *Financial Transactions in Japanese Law*, in ODA & GRICE, *supra* note 65, at 6, 21. Under the regulations to the Financial System

Despite the scope of these activities, Article 65 has kept the banks out of various potentially lucrative securities activities, including retail brokerage and equity underwriting.⁶⁸ This has kept the banks lobbying for expanded securities powers in a back-and-forth struggle with securities companies seeking expanded bank powers. In 1981, the banks won a major struggle to deal in and make retail sales of government bonds.⁶⁹ At about the same time, however, securities companies were given the right to market interest-bearing, medium-term government bond funds to the public at a higher interest rate than available through the banks, and to make loans to customers on the collateral of public bonds.⁷⁰ Since "securities" are narrowly defined, each new financial product sought to be introduced, and each proposed entry into a new field of business, may raise Article 65 issues, requiring examination by the Securities and the Banking Bureaus of the MOF and turf allocations between the securities and banking industries.⁷¹ While this examination process may be useful to the MOF in various ways,⁷² the piecemeal approach to dismantling Article 65 has become increasingly time-consuming. At the same time, the need to maintain the specialized financial

Reform Law announced in December 1992, the "three bureaus guidance" is to be abolished (*haishi*) (subject, however, to a gradual five year phase out period). Press Release, on "Concerning an Outline of Implementation of the Financial System Reform," Okurashō, Dec. 17, 1992, item 5.1 [hereinafter Press Release].

68. The Antimonopoly Law in Japan prevents banks from acquiring a brokerage business as a wholly owned subsidiary, although, as stated *supra* note 54, many banks have close ties to brokerage firms. Until the stock market declines of the last few years, brokerage commissions in Japan (still fixed-basis only) have been extremely lucrative. VINER, *supra* note 6, at 76-78.

69. See Rosenbluth, *supra* note 11.

70. See generally THE JAPANESE FINANCIAL SYSTEM, *supra* note 13, at 262-63.

71. Struggles over retail sales of government bonds and sales of commercial paper are described in Rosenbluth, *supra* note 11, and Litt et al., *supra* note 59, respectively. See also VINER, *supra* note 6, at 29-34. Banks were allowed in 1989 to trade bond futures on behalf of their customers, *Japan Set to Nix Investment Banking Barriers*, CORPORATE FINANCING WEEK, July 10, 1989, at 1, while securities firms were permitted in 1990 to offer a variety of new foreign exchange-related products (reserved to banks) and securities products that combined commodity and currency futures with real estate, stocks and bonds. Kyle Pendragon, *Japanese Banks Flourish Under Article 65 Rules*, FUTURES; THE MAGAZINE OF COMMODITIES & OPTIONS, Aug. 1990, at 53.

72. The need for institutions to obtain MOF's approval before embarking in a new direction obviously reinforces and enhances MOF's control over the activities of those firms, while at the same time permitting MOF to assess the implications the new product may have for the Japanese markets before the product is introduced. Also MOF may use the carrot of expanded securities or bank powers, or characterization of a new product as a "security" or not, in order to obtain concessions from the banking or the securities industry.

system has decreased. These shifts have therefore laid the groundwork for the recent changes to Article 65 embodied in the Law.

B. *The Financial System Reform Law of 1992*

1. The Advisory Council Reports

In the 1980s, recognizing the big-picture issues posed by the changes in the world-wide financial system and increasingly dissatisfied with a piece meal approach to resolving Article 65 issues, the MOF requested two of its advisory councils,⁷³ the Financial System Research Council and the Securities and Exchange Council, to address the issue of overall structural reform of the Japanese financial system, including Article 65.⁷⁴ While these councils are not industry trade groups, and while members of the banking and securities industries sit on each council, the two councils represent to a considerable extent the views of the banking and the securities industries, respectively. These councils published a series of reports beginning in December 1987, and ending with the publication of final reports of both councils in June 1991.⁷⁵ These final reports, in principle, provided the basis for the MOF's draft of the Financial System Reform Law.⁷⁶

73. Advisory councils, or *shingikai* (literally, "deliberation councils"), are standing or ad hoc committees attached to Japanese ministries whose purpose is to investigate, to debate and to advise the ministry on whatever issues may be referred to it. Composed of "persons of learning and experience," advisory councils are to represent a cross-section of interests, drawing on academics, industry leaders, journalists and members of other constituencies that could be affected by the measures to be considered; however, the councils tend to become bargaining grounds between the government and the industries concerned. The councils' reports in principle form the basis for legislation ultimately proposed to the Diet by the government. See Yung Ho Park, *Governmental Advisory Commission System in Japan*, 3 J. COMP. ADMIN. 435 (1972).

74. The Financial System Research Council (*Kinyū Seidō Chōsakai*) is designed to address issues affecting the financial system in the broadest sense, but the interests of the banks are heavily represented. The Securities and Exchange Council (*Shōken Torihiki Shingikai*) is directly attached to the Securities Bureau and tends to reflect securities industry interests.

75. FINANCIAL SYSTEM RESEARCH COUNCIL FINAL REPORT, *supra* note 45; SECURITIES AND EXCHANGE COUNCIL FINAL REPORT, *supra* note 23. For a thorough discussion of these reports, see David G. Litt, *Work in Progress at the Ministry of Finance: Proposals for Restructuring the Japanese Financial Services Industry*, 12 U. PA. J. INT'L BUS. L. 711 (1991); Royama, *supra* note 4.

76. The process of long deliberations of the advisory councils, behind-the-scenes maneuvering, and step-by-step pre-compromises by industry groups and the government is characteristic of Japanese political decision-making. While this may appear from the

The advisory councils were asked to decide (among other issues) which of the following five different bases of bank securities business would be optimal for Japan: integration of activities through an ad hoc, piecemeal approach; operation of securities activities through a specialized subsidiary; operation of securities activities through a subsidiary which itself would be multi-functional (combining for example trust banking and securities activities); concurrent operation of securities activities within the bank, or true universal banking; and operation of banking and securities activities through an ultimate parent holding company structure, as under the Bank Holding Company Act in the United States.⁷⁷

The piecemeal approach was rejected on several bases: first, that it would not permit a coherent system of mutual entry into banking and securities businesses; second, that it would not lead to an internationally "acceptable" system; and, finally, that it failed to incorporate sufficiently the users' point of view.⁷⁸ The holding company structure, while recognized to have various advantages,⁷⁹ was rejected as inconsistent with Article 9 of Japan's Antimonopoly Law, which flatly prohibits all holding companies unless the approval of the Fair Trade Commission is obtained.⁸⁰

In their final reports, both councils rejected universal banking.⁸¹ Among the problems cited at various stages of the reporting process were: (1) the threat of conflicts of interest;⁸² (2) the

outside to reflect a cultural desire to reach harmonious compromise, each industry group jockeys to protect its self-interest, while the government seeks to preserve its administrative authority and to promote its separate agenda as best it can. Even the compromise process is often not complete: in the case of the Financial System Reform Law, many issues were left unresolved. See Litt, *supra* note 75, at 753.

77. 12 U.S.C. §§ 1841-1850 (1988).

78. SECOND FINANCIAL SYSTEM COMMITTEE OF THE FINANCIAL SYSTEM RESEARCH COUNCIL, ON A NEW JAPANESE FINANCIAL SYSTEM (INTERIM REPORT) (Federation of Bankers Ass'n of Japan trans., 1989) [hereinafter FINANCIAL SYSTEM RESEARCH COUNCIL INTERIM REPORT]; FINANCIAL SYSTEM RESEARCH COUNCIL FINAL REPORT, *supra* note 45, at 20.

79. The holding company approach was recognized to provide a certain degree of protection against conflict of interest problems, FINANCIAL SYSTEM RESEARCH COUNCIL INTERIM REPORT, *supra* note 78, at 42; SECURITIES AND EXCHANGE COUNCIL FINAL REPORT, *supra* note 23, at 15.

80. Antimonopoly Law, *supra* note 51, art. 9. Japan is virtually unique in maintaining such a flat ban on holding companies. The prohibition is sensitive because it was a cornerstone of Occupation efforts to prevent the recreation of the *zaibatsu*, which operated through classic holding company structures.

81. FINANCIAL SYSTEM RESEARCH COUNCIL FINAL REPORT, *supra* note 45, at 21; SECURITIES AND EXCHANGE COUNCIL FINAL REPORT, *supra* note 23, at 15, 17.

82. FINANCIAL SYSTEM RESEARCH COUNCIL FINAL REPORT, *supra* note 45, at 40-42;

inability of management of universal banks to provide independent and sound management as a securities company and so contribute to the development of the capital markets;⁸³ (3) concerns that universal banks could dominate their customers and smaller competition;⁸⁴ (4) the unfair access that banks would have to funding from the Bank of Japan and to insured deposits;⁸⁵ and, (5) concerns over the unfair use of inside information.⁸⁶ The securities and banking industries took different positions, however, about whether these problems are transitional or fundamental. The Financial System Research Council hedged its bets by stating that the universal banking system "has many problems *at this point* in terms of maintaining sound banking management and preventing harmful conflicts of interest," and by noting that debt private placements and underwriting, dealing, etc., of public bonds were already being conducted at the bank entity level.⁸⁷ By implication, the banks suggest these issues can be solved through regulatory means in the future. The Securities and Exchange Council, on the other hand, has emphasized that Article 65 has the additional purpose of avoiding banks' dominance of the markets, and that this will not simply be a transitional problem.⁸⁸

The remaining areas of focus were single-purpose and multi-functional subsidiaries. Multi-functional subsidiaries would be able to operate in a variety of areas presently required to be conducted by discrete entities, such as securities business and trust banking business, while single-purpose subsidiaries would be able to operate in only one area. Even in the multi-functional subsidiary case, however, deposit-taking functions were proposed to be isolated from non-banking business activities, and/or the subsidiary was to perform only wholesale busi-

SECURITIES AND EXCHANGE COUNCIL FINAL REPORT, *supra* note 23, at 15.

83. SECURITIES AND EXCHANGE COUNCIL FINAL REPORT, *supra* note 23, at 15.

84. SECURITIES AND EXCHANGE COUNCIL FINAL REPORT, *supra* note 23, at 15.

85. FINANCIAL SYSTEM RESEARCH COUNCIL INTERIM REPORT, *supra* note 78, at 40. The text does not list problems noted in the order raised in the report.

86. FINANCIAL SYSTEM RESEARCH COUNCIL INTERIM REPORT, *supra* note 78, at 40.

87. FINANCIAL SYSTEM RESEARCH COUNCIL FINAL REPORT, *supra* note 45, at 21 (emphasis added). Although the banks had initially called for adoption of universal banking, Linda Sieg, *Japan Banks Step Up Push for Universal Banking*, Reuters, Dec. 14, 1988, available in LEXIS, Nexis Library, Reuters File, by the time of its interim report the Financial System Research Council already was willing to agree that the "leap to universal banking in one bound may be too drastic," FINANCIAL SYSTEM RESEARCH COUNCIL INTERIM REPORT, *supra* note 78, at 38.

88. SECURITIES AND EXCHANGE COUNCIL FINAL REPORT, *supra* note 23, at 15, 18.

ness activities, in order to protect the retail customer.⁸⁹ To the Securities and Exchange Council, the multi-functional subsidiary approach seemed to represent a possible first step to universal banking, while the banks found only that multi-functional subsidiaries deserved "further study."⁹⁰ The approach finally proposed was to require separate subsidiaries for each discrete activity, for several reasons: (1) management of different risks associated with different types of enterprises would be simplified; (2) disclosure would be promoted, and inside information and other conflict of interest risks would be decreased; (3) adjusting for inequities in competitive conditions such as number of branch office locations would be simplified; (4) competition among types of business would be more focused and the benefits of competition brought more quickly to consumers; and, (5) regulatory supervision would be simplified.⁹¹ Both councils agreed that securities subsidiaries of banks should be excluded from the stock brokerage business "for the time being."⁹²

2. The Law

The Financial System Reform Law (the Law), passed by the Japanese Upper House on June 19, 1992, adopts the councils' proposals for the separate subsidiary approach to mutual entry, by permitting banks and securities firms to own majority-owned subsidiaries in other fields.⁹³ In a number of important respects, the Law increases the scope of bank securities powers, even without establishing a securities subsidiary. The Law removes commercial paper and certain loan trusts from the scope of Arti-

89. FINANCIAL SYSTEM RESEARCH COUNCIL INTERIM REPORT, *supra* note 78, at 40.

90. FINANCIAL SYSTEM RESEARCH COUNCIL FINAL REPORT, *supra* note 45, at 21.

91. FINANCIAL SYSTEM RESEARCH COUNCIL FINAL REPORT, *supra* note 45, at 22-23.

92. SECURITIES AND EXCHANGE COUNCIL FINAL REPORT, *supra* note 23, at 18; FINANCIAL SYSTEM RESEARCH COUNCIL FINAL REPORT, *supra* note 45, at 23. The reports of the councils, which address in a cursory manner only those issues directly related to universal banking, raise a great many more issues than those cited in the text. By demonstrating the substantial agreement of the councils on the issue of separate subsidiaries, moreover, the text suggests a greater degree of agreement than there actually was. See Litt, *supra* note 75, for a thorough discussion of those reports.

93. Financial System Reform Law, *supra* note 5, arts. 43-2, 65-3. Presumably the option of owning a less than wholly-owned subsidiary is intended to permit banks to establish securities subsidiaries in conjunction with other shareholders, to avoid unnecessary expenditures. The opportunity for joint ownership suggests that a main bank's *keiretsu* members may be potential partners approached, a pattern that will reinforce *keiretsu* allegiances. Regulations announced so far, see note 109 *infra*, do not address this. Alternatively, minority interests in subsidiaries could be spun off to the public.

cle 65 prohibitions,⁹⁴ and expressly authorizes banks to handle private placement business in other securities.⁹⁵ Private placements are defined clearly for the first time,⁹⁶ and the concept is expanded to permit sales to an unlimited number of "qualified institutional investors."⁹⁷ Furthermore, the Law fails to redefine "securities" in a general way.⁹⁸ This means that the MOF will still be required to approve separately the "security" status of each new product sought to be introduced in Japan, and that the banks may continue to deal directly in products, including securitized products, not specifically enumerated as securities.⁹⁹

The Law itself specifies few "firewalls"¹⁰⁰ between parent and subsidiary institutions, although these were much discussed

94. Financial System Reform Law, *supra* note 5, art. 65, ¶ 2, items (2), (3).

95. Financial System Reform Law, *supra* note 5, art. 65, ¶ 2, item (4). Regulations under Article 10 of the Banking Law will also be amended to clarify that handling of privately placed securities is a permitted ancillary banking activity.

96. Financial System Reform Law, *supra* note 5, art. 2, ¶ 3.

97. All purchasers must be qualified institutional investors (*tekikaku kikan tōshika*) and there must be very small risk that the securities may be transferred by public offering or to investors other than qualified institutional investors. Financial System Reform Law, *supra* note 5, art. 2, ¶ 3, item (2).

98. Commercial paper and mortgage-backed trust certificates have been added to the list, but lease-backed and other credit-backed securities were left out in deference to the MITI under whose jurisdiction such instruments presently fall. Such instruments will now have to be defined as securities in a separate "Law for the Regulation of Specified Claims." See *What Happened to the Report of the Advisory Councils?*, CAMRI Rev., Apr. 30, 1992, at 37. The Securities and Exchange Council had proposed a broad definition of securities, as any certificate or instrument representing the status or right of a party to a contract or arrangement with the characteristics that: (i) the investor contributes funds which the recipient uses to run or manage a business, (ii) funds contributed be invested or managed by the party receiving them, (iii) the investor has the right to receive distributions in accordance with the investment contract, and (iv) the investor's rights may be assigned. SECURITIES AND EXCHANGE COUNCIL FINAL REPORT, *supra* note 23, at 4.

99. The securitized products area is very large, since Japanese banks shed about ¥2.3 trillion in loan assets in fiscal 1992 to comply with BIS standards. See *What Happened to the Report of the Advisory Councils?*, *supra* note 98, at 37; *Securitization of Loans Up Sharply*, THE NIKKEI WEEKLY, Apr. 5, 1993, at 17. The failure to include securitized products as securities means that disclosure rules will not apply to sales, and that sales must be limited to large investors in private transactions, which will not promote transparency of the markets. Former Securities Bureau Chief Nobuhiko Matsuno, *Current Issues Facing the Securities Administration*, CAMRI Rev., Aug. 31, 1992, at 2, 4.

100. The "firewall" discussion in Japan has a different focus from that in the United States, where the focus is on limiting bank financial liabilities to non-banking affiliates to prevent drains on bank capital in times of financial crisis for the affiliates. In Japan the focus of discussion is the need to maintain a competitive balance, or level playing field, between securities and banking firms.

by the Securities and Exchange Council.¹⁰¹ This is a victory for the banks since firewalls implemented by regulation, or informal administrative guidance, may much more easily be modified than firewalls established by law. The Law itself states only that: (1) affiliated banks and securities companies shall not have common directors or statutory auditors;¹⁰² (2) securities firms may not conclude contracts with customers if they know their bank parent or subsidiary to have provided financing to the customer conditioned on such customer's purchase of the securities;¹⁰³ and, (3) transactions are prohibited if they are on terms that are not arms length *and* if they would "threaten to injure the fairness of trading."¹⁰⁴ Other prohibited acts are left to be determined by ordinance.¹⁰⁵

One clear, if temporary, victory for the securities industry is that bank securities subsidiaries are restricted by the Law from conducting retail brokerage "for the time being," in order to

101. The Securities and Exchange Council stressed the particular ability of Japanese banks to influence their corporate customers, and so obtain large numbers of issuers as clients among their *keiretsu* members on this basis rather than on the basis of competitive securities skills or pricing. To this end, the Council sought measures (i) to ensure independence and soundness of management of new securities firms, by express allocations of risks between parent and subsidiary and by prohibiting excessive dependence by subsidiaries on transactions with certain parties; (ii) to prevent conflicts of interest arising through underwritings of the bank parent's own securities or of issuers from which the bank parent seeks to collect bad loans; (iii) to promote fair competition by restricting subsidiaries' issuances of securities to investors on very favorable terms in return for engaging in business with the subsidiary; (iv) to prevent bank parents from giving business to their securities subsidiaries on concessionary terms, and to prevent bank parents from purchasing securities underwritten by their subsidiaries within a stated time period after issuance; (v) to prevent disclosure of non-public customer information by a bank parent company to its subsidiary; and, (vi) to prevent interlocking directorships or joint use of office space between a parent and a subsidiary. Furthermore, the Securities and Exchange Council sought to have existing relationships between banks and their affiliated securities companies investigated and measures taken to prevent abuses. SECURITIES AND EXCHANGE COUNCIL FINAL REPORT, *supra* note 23, at 17-18.

102. Financial System Reform Law, *supra* note 5, art. 42-2. This will not prevent the transfer of directors or employees between companies as long as they give up their positions at the first company for the duration of their stay at the subsidiary.

103. Financial System Reform Law, *supra* note 5, art. 50-2, item 2.

104. Financial System Reform Law, *supra* note 5, art. 50-2, item 1. Accordingly non-arm's length transactions, in themselves, are not prohibited. Are transactions which threaten to injure fair trading intended to be permitted so long as they are arms-length transactions? Presumably examples of injuries to fair trading will be forthcoming in the ordinance.

105. Financial System Reform Law, *supra* note 5, art. 50-2, item 3. Even acts prohibited by the Law are subject to exception if the Minister of Finance finds them unlikely to undermine the public interest or the protection of investors. Financial System Reform Law, *supra* note 5, art. 50-2, item 3.

avoid a disastrous competitive situation for the many financially crippled third-tier securities firms whose brokerage revenues have virtually dried up.¹⁰⁶

The Law also takes several steps towards streamlining Japan's segmented financial system. Long-term credit banks and the specialized foreign exchange bank (The Bank of Tokyo) are permitted either to merge with, or to convert themselves into, a financial institution of a different type, including an ordinary bank.¹⁰⁷ Although this leaves the timing of a conversion decision with the banks in question, it is a move toward streamlining Japan's segmented market structure. The Law also abolishes altogether the category of "mutual bank" (*sōgō ginkō*), through repeal of the Mutual Bank Law.¹⁰⁸

3. The Regulations

In December 1992, the MOF announced an outline of the regulations to be implemented under the Law in April 1993.¹⁰⁹ These regulations demonstrate how limited the initial impact of the Law will be in liberalizing bank securities activities, since they sharply limit both the scope of permitted securities activities and the number of banking institutions initially authorized to engage in such activities at all.

Authorized securities subsidiaries will initially (meaning for two or three years) be allowed only to underwrite public bonds,

106. Supplementary Provisions of the Law, *supra* note 5, art. 19. Over 200 so-called third-tier brokerage houses in Japan are at present in serious financial trouble due to the declines in the Japanese stock markets and the consequent collapse of trading volume. The weakened condition of the financial system generally makes mergers, the traditional recourse of the MOF, a difficult strategy to apply, and there is considerable concern about a brokerage house collapse. VINER, *supra* note 6, at 29; *Japan Finance Ministry Considers Letting Foreign Banks Acquire Securities Firms*, [Jan. - June] Banking Rep. (BNA) No. 25 at 1108 (June 22, 1992). Although banks will not be able to establish retail brokerage operations through a securities subsidiary, the possibility is left open that existing retail brokers could maintain existing trading in debt securities if taken over by a Japanese bank. The MOF has also expressed a receptive attitude towards the possibility of foreign bank takeovers of Japanese brokerage houses, and has suggested that a foreign bank may be able to retain equity retail brokerage licenses in such a case. *Id.*

107. The Law amends the Law Concerning Conversion or Merger of Financial Institutions, Articles 3, 4.

108. Law No. 199 of 1951. The former mutual (*sōgō*) banks had already converted themselves into ordinary banks in the last few years. THE SECOND ASSOCIATION OF REGIONAL BANKS, THE NEW REGIONAL BANKS OF JAPAN 1991, at 1 (1991).

109. Press Release, *supra* note 67. See also *MOF Determines Details of Financial Deregulations*, Japan Economic Newswire, Dec. 17, 1992, available in LEXIS, Nexis Library, OMNI File.

nonconvertible corporate bonds, and certain equity-linked securities (convertible bonds, bonds with warrants and warrants), and to act as broker or dealer for public bonds and nonconvertible corporate bonds (but not equity-linked securities);¹¹⁰ they will be expressly barred under the regulations from engaging in equity underwriting or trading.¹¹¹ This represents only a modest advance over securities activities of banks currently permitted under the present Article 65.

Furthermore, only long-term credit banks and trust banks (ten in all), and central cooperative institutions (principally the government-controlled Norinchukin Bank), will be eligible to engage in such activities for an initial period of one year. Even then, only those institutions which "place priority" on securities activities will be eligible (implying that long-term credit banks must choose either to establish securities subsidiaries or trust bank subsidiaries).¹¹² The establishment of securities subsidiaries will be further limited so as to avoid "confusion" in the market that could be caused by excessive entry of new institutions into the securities business at the same time (giving the MOF its queuing powers over applications).¹¹³ As an overarching limitation, all of such liberalizing steps are to be considered (and presumably are subject to reevaluation) in light of various factors such as general conditions in the market, the reform measures' influence on business operations, the condition of parent companies, the situation after implementation of the reforms, and (hardly as a priority) the purpose of the reforms.¹¹⁴ The minimum capital for securities companies which seek to act as managing underwriters authorized to conduct negotiations with issuers — and therefore authorized to discuss underwriting fees — will be more than tripled from the present level of three billion yen to ten billion yen.¹¹⁵

110. Press Release, *supra* note 67, intro. para., item 1. Securities subsidiaries may trade in the last-mentioned securities to the minimum extent necessary in connection with their underwriting of such securities.

111. Trading and underwriting in stock index futures and options, and trading in equity-linked securities, are expressly prohibited.

112. Press Release, *supra* note 67, item 3.1. Similarly, those securities companies, long-term credit banks, specialized foreign exchange banks (i.e., The Bank of Tokyo) and central cooperative credit institutions which place priority on trust bank activities are to be permitted to establish trust bank subsidiaries.

113. Press Release, *supra* note 67, item 3.4.

114. See, e.g., Press Release, *supra* note 67, items 3.2, 3.3, intro. para.

115. Press Release, *supra* note 67, item 3.5; Securities and Exchange Law Cabinet Enforcement Order Article 15, item 1(1) (1991). It appears, although it is not clear, that

The regulations also list a series of firewalls¹¹⁶ that will limit the ability of banks' securities subsidiaries to take advantage of their parents' banking relationships with customers.¹¹⁷ A securities subsidiary may not lead-manage an issue if its parent bank is the lead commissioned company for the issue (or if its parent bank has acted as lead commissioned company in over half of that issuer's offerings in the previous two years), unless the issuer has net assets in excess of 500 billion yen and is therefore presumably not under the parent bank's control.¹¹⁸ Joint visits by securities subsidiaries and parent banks are prohibited, except upon a customer's request.¹¹⁹ Non-public information concerning customers or issuers is not to be received or offered between parent banks and securities subsidiaries.¹²⁰ Securities subsidiaries are to aim for a level of fifty percent permanent employees within a period of five years after establishment; executives with representation power of the securities subsidiary may not become executives of the parent bank; and other executives are not to become executives of the parent bank, nor work in its securities department, for two years after leaving the securities subsidiary.¹²¹ Also, securities subsidiaries are not permitted to have their head office in the same building as the main office of their parent banks, nor may securities subsidiary branches, oper-

this ¥10 billion level will apply to newly established securities companies only, and not existing securities companies. The implications for foreign securities firms may be significant, since unless they are willing to commit such amounts of minimum capital they will be unable to conduct underwriting fee negotiations. By limiting the number of entrants, the securities market will therefore remain a fixed fee area, without a free market in negotiated fees. This provision raises questions about the MOF's motives, especially if existing firms are grandfathered while only new firms are required to meet this higher threshold. Minimum bank capital meanwhile is to be raised to ¥2 billion.

116. Literally, "measures for the prevention of harmful effects" (*heigai bōshi sochi*). These are principally directed not towards stemming capital flows between securities activities and bank activities, but toward preserving the competitive balance between the industries as a political matter.

117. The regulations refer to "parent financial institutions," but the text will refer to parent banks.

118. Press Release, *supra* note 67, item 1.2.1. This will permit a bank such as the Industrial Bank of Japan to act as lead commissioned company, while its securities subsidiary acts as lead manager, for bond issues of major Japanese corporations, regardless of the parent bank's relationship with that corporation.

119. Press Release, *supra* note 67, item 1.2.2.

120. Again, unless written agreement of the customer is obtained. Press Release, *supra* note 67, item 1.2.3. The specifics of what constitutes non-public information are to be developed by the banking and securities self-regulatory institutions.

121. This rule is to be supplemented by self-regulatory measures. Press Release, *supra* note 67, item 1.2.4.

ations premises, computer facilities, dealing rooms, etc. be shared with the parent bank.¹²²

Other firewalls are more briefly listed, presumably to be detailed further: (1) restrictions are to be placed on the ratio of securities subsidiaries' revenues arising from transactions with the parent bank; (2) lead underwriting by securities subsidiaries of securities issued by their parent banks is to be restricted; (3) if securities subsidiaries underwrite securities for borrowers of their parent banks, they are required to disclose the possibility that funds so raised may be applied towards repayment of loans by such issuers to the parent; (4) securities subsidiaries are not to make tie-in sales with their parent banks; (5) securities subsidiaries are not to make sales of securities if they are aware that their parent bank has extended credit to customers to finance the purchase of such securities; (6) securities subsidiaries are to apply arms-length rules to transactions with their parent banks; and, (7) sales of securities underwritten by securities subsidiaries to their parent banks will be restricted.¹²³

4. Evaluation

As amplified by these regulations, the Law will have only minimal impact on securities competition in Japan for at least several years. This reflects in part MOF's judgment that Japan's current financial instability makes virtually any new securities activities too risky for the banks and too threatening for the securities firms that would be required to compete with them. However, it also reflects MOF's desire to orient the long-term credit banks and trust banks in a new direction, while at the same time promoting the development of a corporate bond market.

By permitting the merger or conversion of the long-term credit banks and The Bank of Tokyo into ordinary banks, the Law signals that the original function of these specialized institutions is no longer needed. Indeed, their continued independence is a drag on the development of the corporate bond market, which they have steadfastly opposed since an open corporate bond market would both undercut their special role of

122. Press Release, *supra* note 67, item 1.2.5.

123. Press Release, *supra* note 67, item 1.2.6. All of such measures will presumably be clarified in the actual MOF regulations, or more likely, in subsidiary interpretive releases, notifications, etc..

supplying long-term funds and sharply reduce their fee income as commissioned companies.¹²⁴ The regulations will therefore give the long-term credit banks and the trust banks a head start in the securities business over competitor city banks (with their much larger branch and deposit base). The downturn in the equity markets, however, must be a sharp disappointment to these banks, since wide equity underwriting spreads will not be available during this head-start period.

The Law is also one step in a variety of measures being undertaken to promote a domestic corporate bond market in Japan.¹²⁵ Surprisingly, in view of the size of Japan's financial resources, a corporate bond market has never fully developed in Japan, partly as a reflection of the historical ability of the *zaibatsu* banks to finance their group operations internally, but also as a reflection of outright governmental restrictions on corporate bond borrowings, to enhance control over the channeling of funds to targeted sectors of the economy.¹²⁶ Since the long-term credit banks and trust banks were established to perform the long-term funding functions of an open corporate bond market, these institutions became institutional barriers to that market's development. Still another barrier has been the lack of a

124. Such fees have been more than ten times the fees for corresponding services in the Euromarkets (e.g., ¥53 million for a ¥10 billion bond issue versus an estimated ¥3.5 million in the Euromarkets). Brian W. Semkow, *Japan's 1992 'Big Bang' and Other Financial Reform*, 3 J. INT'L BUS. L. 89, 93 (1992). Such fees would drop dramatically if Japan's corporate bond market were liberalized.

125. See FINANCIAL SYSTEM RESEARCH COUNCIL FINAL REPORT, *supra* note 45, at 25-26, for recommendations. The Ministry of Justice has completed a draft of revisions to the Commercial Code to be submitted to the Diet currently in session. The revisions will lift the current restrictions on corporate bond issuances, which limit unsecured bond issuances to the amount of an issuer's net assets and limit secured bond issuances to twice that amount (as reduced to give account to unsecured bond issuances). With exceptions for certain private placements, issuers will be required to appoint bond commissioned companies in conjunction with their bond issues as an additional measure of investor protection (perhaps permitting a role for commercial banks not yet authorized to underwrite the bonds). This will effect a significant change in the Japanese bond markets, and reflects a shift in attitude towards much greater reliance on securities disclosure and bond rating systems, as well as the principle of investor responsibility. Correspondence from Japanese attorneys (February 1993) (on file with author).

126. To exert control over the economy by rationing the supply of credit, the Japanese military authorities in the 1930s and 1940s restricted the ability of corporations to issue bonds directly, requiring corporations to rely entirely on the banks for their financing. TSUTSUI, *supra* note 8, at 14. This pattern was continued after the war, when corporations were encouraged to turn to the long-term credit banks for long-term funds, with very limited amounts of bonds being issued. Bonds which could be issued, moreover, could only be issued on a secured basis, because of great losses in the late 1920s. THE JAPANESE FINANCIAL SYSTEM, *supra* note 13, at 43-44; TATEWAKI, *supra* note 17, at 83-85.

bond rating system and procedures, although at least five rating agencies now exist in Japan.¹²⁷

A domestic bond market is now needed in Japan, since the many Japanese companies that issued convertible and warrant bonds in the Euromarkets in the 1980s (at very low interest rates) find that as the maturities of these bonds become due, the bonds cannot be converted into equity and must be refinanced at much higher rates.¹²⁸ The Law tends to promote this market by opening debt securities underwriting to the long-term credit banks and trust banks, which have a strong incentive to develop these markets ahead of the city banks.

On many other issues, the Law will not have the impact it was hoped to have as recently as last year.¹²⁹ The Law itself reflects the deadlock of the councils on a number of key issues, and so left the status quo as it was or deferred issues for later resolution by the MOF.¹³⁰ In its announced implementation of the Law, the MOF has used that deadlock, in Japan's current unstable financial situation, as the basis for justifying very little liberalization at all. As a result, no industry participants seem happy with the Law, other than perhaps the third-tier brokers. For the securities industry, the Law falls very far short of adopting reforms considered required: "securities" are not comprehensively defined (in particular, securitized products are not generically included),¹³¹ while banks are permitted to undertake a good deal of securities business directly and the eventual prospect of increased competition through bank subsidiaries looms heavy. Under the announced regulations, the restrictions on se-

127. TATEWAKI, *supra* note 17, at 85.

128. The collapse of the Japanese stock markets dashed hopes of conversion of convertible and warrant bonds to equity, leaving \$134 billion in debt to be refinanced in 1992 and 1993, and another \$35 billion in 1994. Alps Electric Co., an electronics parts maker, has found that it must pay 7% in the Euromarkets today rather than 3% in the 1980s, despite the overall decline in dollar interest rates. Hardy, *supra* note 64, at C1.

129. It was hoped as recently as March 1992 that the passage of the Law would mean that Japan's Glass-Steagall firewalls would come "tumbling down," with banks and securities firms able to enter each others' areas freely by March 1993. See, e.g., *Japan Financial Woes Break Logjam for Reform of Banking System*, THOMSON'S INT'L BANKING REGULATOR, March 23, 1992, at 1.

130. The *shingikai* reports themselves stopped short of tackling the biggest problems they were supposed to address. See, e.g., Litt, *supra* note 75, at 752 (reform proposals fail to transcend financial politics and seem instead to be a series of piecemeal accommodations that do not change the basic features of the system).

131. See, e.g., Emiko Terazono, *Investment Innovations on Horizon in Japan*, FIN. TIMES, Feb. 14, 1992, at 21 (characterization of asset-backed securities as "securities" will promote development of market in Japan).

curities firms' ability to conduct banking or trust banking business through subsidiaries are themselves so heavy that even Nomura Securities has indicated it may delay its entry into the area.¹³² The city banks meanwhile regard the reforms announced under the regulations as "little better than nothing," and are resentful of the long-term credit banks' underwriting powers.¹³³

The failure to broaden the definition of "securities" reflects a missed opportunity for the MOF itself, since products such as real estate securitized interests (under supervision of the Ministry of Construction) and lease and installment sale securitized products (under supervision of the MITI) could have been brought under the protective umbrella of disclosure rules, anti-fraud provisions, and the MOF's own supervisory jurisdiction. As the gatekeeper over the speed at which liberalization will now proceed, MOF's authority over its regulated institutions remains intact, but the dissatisfaction of those institutions will create continued political pressures on MOF to give way. If securities markets remain depressed, and the securities industry finds itself unable to retain its former political clout with Japan's politicians, the balance of power that Article 65 has provided between securities and banking firms is likely to shift decidedly towards the banks.¹³⁴

IV. CONCLUDING OBSERVATIONS

Japan's regulatory authorities have continued a slow process of liberalization based on four broad principles: (1) that enhanced competitiveness in the financial service industry is a necessary condition for increasing the availability of assets and services to the economy; (2) that the financial structure must be internationally compatible with other financial structures, especially those of major industrial powers; (3) that the financial structure must reduce the potential for unfair trade practices;

132. Trust bank subsidiaries will be kept out of what are considered to be the most profitable trust business areas, including loan trusts and specified money trusts (*tokkin*). *MOF Determines Details of Financial Deregulations*, *supra* note 109.

133. *MOF Determines Details of Financial Deregulations*, *supra* note 109.

134. Article 65 has accomplished at least one of its original purposes by protecting the securities industry against incursion by the banks, and so permitting them to develop political strength now roughly comparable to that of the banks. Rosenbluth, *supra* note 11, at 63, 68. Whether this rough equality will continue is an open question, for the political strength of the securities industry is linked to its ability to make political donations; and that ability in turn is linked to the level of activity in the stock markets. Rosenbluth, *supra* note 11, at 67.

and, (4) that the financial system must be able to manage risk in such a manner as not to increase system risk.¹³⁵ This has resulted, in the broadest sense, in a slow process of "securitization" of Japan's financial system, away from bilateral, negotiated, or customer-based ways of obtaining liquidity to methods that rely on the exchange of assets for liquidity in open, less regulated, and wide participation markets.¹³⁶

These changes have been very gradual, however, even under good economic conditions. Japanese regulators are very wary of any "Big Bang" approach to financial liberalization and become anxious at the thought of unleashing the resources of the private sector in an unfettered free market.¹³⁷ They have accordingly sought to guide the direction, and control the speed, of liberalizations as much as possible. This tendency has led some observers to refer to Japan's transition process as "*bonsai*" liberalization, in which regulatory authorities are not willing to permit competitive forces to play the same role they do in western financial systems.

When economic conditions are difficult, this tendency is magnified so that liberalization may virtually grind to a halt. Certainly the timing of the Law is not auspicious for expanded bank powers: Japan's stock and real estate market reversals and its non-performing bank loan problems have raised questions about the stability of the banking system¹³⁸ and the role of gov-

135. Thomas F. Cargill & Shoichi Royama, *The Evolution of Japanese Banking: Isolation to Globalization*, in FEDERAL RESERVE BANK OF CHICAGO, GAME PLANS FOR THE '90S: THE 26TH ANNUAL CONFERENCE ON BANK STRUCTURE AND COMPETITION 491, 497-98 (1990).

136. The effects of this securitization process can be seen in four areas: (1) the decline in the indirect finance ratio since 1975; (2) the decline in the market share of the banking system; (3) the decline in the role of negotiated transactions in the flow of funds; and, (4) the decline in the role of the main bank system. Statistics on these trends can be found in CARGILL & ROYAMA, *supra* note 1.

137. As expressed by former Securities Bureau Director General Matsuno, "we are not in a position to make risky experiments. We have to take a go-slow approach by determining possible risks step-by-step along the way." Matsuno, *supra* note 99, at 7. The United States view appears to hold that economic regulation must be justified by reference to clear evidence of dysfunction in unregulated markets; otherwise, any interference with competitive market forces will be considered unnecessary or even counterproductive. See Helen A. Garten, *Subtle Hazards, Financial Risks, and Diversified Banks: An Essay on the Perils of Regulatory Reform*, 49 MD. L. REV. 314 (1990).

138. Japanese depositors are withdrawing funds from the ordinary banks for deposit to the postal savings system, apparently out of concern for the financial condition of the banks. See Clay Chandler, *Japan's Banks Find Tough Rival in an Aggressive Postal System*, WALL ST. J., Oct. 29, 1992, at A10. Meanwhile private estimates place the financial industry's non-performing loan portfolio as high as ¥30 trillion, or \$240 billion at

ernment deposit guarantees. The government has responded in a number of ways that raise questions about the future path of Japanese finance. In August 1992, the government permitted temporary accounting adjustments to reduce the balance sheet impact of declining securities markets, reminiscent of United States regulatory authorities' practice of forbearance.¹³⁹ In September, the government announced a major stimulus package of almost 80 billion dollars to reverse the decline of the stock market.¹⁴⁰ While the stock market has responded positively, questions remain about the longer-term condition of the Japanese economy.

The minimal liberalizations permitted by the regulations, after such a long period of discussion and debate, indicate how great the regulatory power of the MOF remains, and to what extent the passage of the Law itself is only a blip along a line of controlled shifts in the ordering of the financial system led by the MOF. The work of the advisory councils over a five year period gave industry, academics, "users," and government regulators a say in how a new financial system should be ordered. This permitted a consensus to be reached that allowed the final bill, once submitted to the Diet, to be acted on quickly and with little debate.¹⁴¹ At a time when the Glass-Steagall reform process in the United States has been deadlocked,¹⁴² the Japanese process in financial reform seems enviable.¹⁴³

current exchange rates, of which "a third is viewed as completely unrecoverable." Jon Choy, *Japanese Banks Attack Problem Loans*, JAPAN ECON. INST. REP., Feb. 5, 1993, at 5. The non-performing loan problem may ultimately end up to be as costly to Japan as the S&L problem has been in the United States. See, e.g., Douglas Ostrom, *A Savings and Loan-Style Crisis for Japan?*, JAPAN ECON. INST. REP., Oct. 2, 1992, at 10-11.

139. Jon Choy, *Government Braces Banks, Sparks Stock Market Rally*, JAPAN ECON. INST. REP., Aug. 28, 1992, at 1-3.

140. Jon Choy, *Tokyo's Big Supplemental Budget Surprises And Pleases*, JAPAN ECON. INST. REP., Sept. 4, 1992, at 1.

141. Some 90% of bills introduced by the Japanese Government in the 1983 Diet session were approved, a figure only somewhat higher than the historical average. Mamoru Seki, *The Drafting Process for Cabinet Bills*, translated in 19 LAW IN JAPAN 168, 169 (1986).

142. The U.S. Congress has proved unwilling or unable to reach consensus on reform of Glass-Steagall. The most recent failed attempt to repeal Glass-Steagall has been the U.S. Treasury proposal to restructure U.S. banking introduced in early 1991. The final outcome of that proposal, however, the Federal Deposit Insurance Corporation Improvement Act of December 1991, did not alter the structure of U.S. banking. See Thomas F. Cargill & Thomas Mayer, *U.S. Deposit Insurance Reform*, CONTEMPORARY POLICY ISSUES, July 1992, at 95, for a discussion of the Treasury proposal.

143. In the absence of Congressional direction, Glass-Steagall liberalization in the United States has been left to piecemeal orders issued by the Federal Reserve Board,

But at the same time, an aspect of the consensus-building effort is that the MOF may place the balancing of vested political interests ahead of real, or even theoretically consistent, financial reform.¹⁴⁴ The failure of the Law to define "securities" comprehensively is an example of this. Indeed, the minimal liberalizations permitted by the regulations suggest that Japanese financial reform announced under the Law is illusory.¹⁴⁵ Preserving the status quo in the competitive balance of the banking and securities industries, avoiding excessive competition in the securities field, and giving the long-term credit banks a lead in securities activities to offset their reduced powers under the new Law are all matters of paramount importance to the MOF regulators -- on equal or higher footing with the underlying goals of transformation of the financial system itself. Tenuous financial conditions have given the MOF sufficient justification to slow the liberalization process, while at the same time reducing the political power of market participants to demand liberalizations, as well as their appetite for them. Real liberalization under the Law is therefore several years off, although, as economic conditions improve and participants demand more strongly the right to engage in new activities that the new Law makes possible, market forces will ultimately overwhelm the MOF's ability to control a *bonsai* liberalization. The shift from traditional financial relationships to more open and competitive ones will therefore be on-going.

As that process resumes, Japan will have to face a fundamental problem not addressed by the Law — the conflict between enhanced opportunities to manage risk and government incentives to assume that risk, including the role of government

which have then been subjected to a validation procedure through industry litigation in the courts, leaving judges to sift through the legislative history from 1933 to reach basic policy decisions concerning our financial system. See Litt, et al., *supra* note 59, for a discussion of the "preclearance" and "postclearance" approaches taken in Japan and the United States over the liberalization of the commercial paper market in each country.

144. It has been suggested that liberalization occurs in Japan only when regulations no longer suit the needs of the financial institutions that benefitted from them in the first place, and that the MOF seeks to adjust the interests of regulated parties only very gradually, to avoid intrusions from the politicians, who have ultimate regulatory authority. This means keeping policy outcomes in line with the political resources of competing groups. Rosenbluth, *supra* note 11, at 101.

145. It is unclear whether the critical opposition to this definition was from the banking industry or from other ministries within the government, who saw a comprehensive definition of securities as a threat to their jurisdiction over a variety of presently unregulated securitized products.

deposit guarantees and moral hazard. As securities activities of banks are slowly permitted to proceed, to what extent will insured deposits (either explicitly insured as in the United States or implicitly insured as in Japan) be used to support those securities activities? Proponents of expanded powers argue that firewalls to restrain capital flows can adequately be designed to separate banking and securities activities. But if the walls are thick enough to insulate insured deposits completely, what happens to the claimed efficiencies resulting from expanded bank powers? And if the walls are not thick enough to insulate insured deposits completely, won't securities risk (or other non-bank activity risk) be subsidized in part by government deposit guarantees?

Japan's traditional view that the full faith and credit of the government stands behind the financial system may generate even more serious problems in the banking system than those that have arisen in the United States. Recent efforts to support the equity markets and to permit accounting adjustments to hide financial problems, and a willingness to permit the postal life insurance system to purchase equities, all suggest that the Japanese regulatory authorities have not fully appreciated the "moral hazard" problem inherent in the conflict between enhanced opportunities to assume risk and risk incentives embedded in government deposit guarantees. Indeed, the global movement toward universal banking has yet to address the problem seriously if judged by the much publicized BIS capital standards.