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Developments in Japanese Securities Regulation: An Overview

This article describes recent developments in securities regulation in Japan.[1] Section I reviews the legal environment in which business firms raise capital in Japanese capital markets. Section II describes recent developments. Sections I and II are illustrative rather than exhaustive, and are intended to be informational rather than analytical. Section III identifies certain elements of Japanese securities regulation that might be viewed as unique to Japan, including regulatory, political, and market environments.

I. The Legal Framework

A. ORGANIZATIONAL FORM

Two of the most important aspects of business planning are the decisions on organizational form and source of capital. Both decisions are influenced by legal rules concerning organizational structure and by prevailing tax rules. In Japan, aside from the sole proprietorship, business can be done in one of six organizational, or legal, forms: *kumiai* (partnership), *tokumeikumiai* (limited partnership), *gomeigaisha* (incorporated partnership), *goshigaisha* (incorporated limited partnership), *yugengaisha* (limited company), and *kabushikigaisha* (stock company).[2]

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1. This article is based on the author's past work, including 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 (1991) [hereinafter Kanda, *Politics*]; Hideki Kanda, *Regulation of Japanese Capital Markets, in* JAPANESE CAPITAL MARKETS (Shinji Takagi ed., 1993); Hideki Kanda & Michael Kawachi, *Securitization in Japan*, JCR FIN. DIG. NO. 36 (1993).

2. Note also that a trust is sometimes used to do business in Japan. The best-known arrangement is called a land trust.

While a detailed description of each of these organizational forms is beyond the scope of this article, some brief notes may be worthwhile.

Among the six forms, only the first two—*kumiai* and *tokumeikumiai*—enjoy single-tiered income taxation, whereby income tax is not imposed at the entity level, but individual investors report in their personal tax returns their proportional shares of the profits earned by the entity. But these two forms do not offer limited liability to their investors and are therefore unpopular for large business in Japan. The other four forms all involve incorporation (some providing investors with limited liability, others not) and are subject to double taxation. While statutes give *gomeigaisha, goshigaisha*, and *yugengaisha* flexibility as to their internal governance structure and related matters, these forms are unsuitable for raising large amounts of funds in the capital market for a variety of reasons. Thus, in Japanese practice, all major businesses take the *kabushikigaisha* form, which is similar to a business corporation in the United States and a public company in the United Kingdom.[3]

Various organizational rules, commonly known as corporate law or company law, are found in the Japanese Commercial Code.[4] Thus, when a business corporation attempts to raise capital by issuing shares or bonds, it must comply with various requirements under the Commercial Code. For instance, the issuance of debt securities must be decided by the board of directors of the company. One unique rule that existed until recently was article 297 of the Commercial Code, which limited the aggregate amount of outstanding bonds and debentures of a *kabushikigaisha*, or stock company, to the amount of the company's net worth. However, the rule provided an exception in that convertible bonds, bonds with stock purchase warrants, and bonds issued outside Japan might be issued up to twice the amount of the issuer's net worth. This entire rule was abolished in 1993.[5]

B. The Securities and Exchange Law

Japan's Securities and Exchange Law (SEL)[6] was modeled on U.S. federal securities laws, specifically the Securities Act of 1933 and the Securities Exchange Act of 1934. To protect investors the SEL provides two basic sets of rules pertaining to mandatory disclosure and antifraud. When a firm attempts to issue securities, as discussed below, it must file with the Ministry of Finance (MOF)

3. Recent studies by economists about Japanese firms have been immense. The key question is whether Japanese and Western firms are different. *See, e.g.*, THE JAPANESE FIRM (Masahiko Aoki & Ronald Dore eds., 1994).

4. Law No. 48 of 1899, as amended.

5. The 1993 amendments to the Commercial Code also include the reform of the bond/debenture system. For instance, the so-called commissioned bank system was abolished on the face of the Code. The reform, however, does not mean that the practice of bank involvement in the bond/debenture finance system will drastically change in the near future.

6. Law No. 25 of 1948, as amended [hereinafter SEL].

a registration statement[7] that must include certain information specified under rules promulgated by the MOF. A company whose securities are listed at a stock exchange, traded over-the-counter, or whose registered shareholders number 500 or more is subject to reporting requirements under the SEL; reporting must be semiannual, and the company's annual report must be audited by a certified public accountant. A company that filed a registration statement with the MOF when it issued securities is subject to the same rules.

Antifraud rules include prohibition of somewhat broadly defined fraudulent activities, such as those prohibited under section 10(b) of the U.S. Securities Exchange Act of 1934, and more specific activities of securities companies, such as fraudulent solicitation of customers. Insider trading is also regulated. An important fact in this area in Japan is that there has been little private litigation associated with the violation of the disclosure or antifraud rules under the SEL.

Japan's legal framework of securities regulation has important differences from that of the United States. First, in Japan, a firm must obtain a license from the MOF to serve as a broker-dealer. The entry barrier to this intermediary service is higher in Japan than in the United States, where registration, rather than licensing, is required for a firm to serve as a broker-dealer.[8]

Second, while the notion of a "security" is broadly defined in the United States, it is limited in Japan. Until 1992 the SEL, in section 1 of article 2, defined a security as one of the following items:

(1) government debt security;
(2) municipal debt security;
(3) debt security issued under a special statute by a corporation;
(4) secured or unsecured debt security issued by a business corporation;
(5) stock issued by a corporation organized under a special statute;
(6) stock and warrant issued by a business corporation;
(7) beneficial certificate under a securities investment trust or loan trust;
(8) security or certificate issued by a foreign government or foreign corporation that has the characteristics of the security or certificate listed in the above (1) - (7); and
(9) any other security or certificate designated by cabinet order.

Although the MOF was empowered to designate any new instrument as a security under item (9), it never exercised this power after the amendments in 1953. Thus, in Japanese practice, the definition of a security was quite limited.

Third, the distinction between a public offering, which is subject to mandatory disclosure requirements, and a private placement, which is not, differs between

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7. Technically, various reports must be submitted to the Minister of Finance. Also, a license for the securities business, for instance, must be obtained from the Minister of Finance.

8. The SEL originally required registration for a broker-dealer. But after the crisis in the securities industry in the early 1960s, the law was amended in 1965; a license is now required. A license is given separately for each type of the four securities businesses specified under the SEL: dealing, brokerage, underwriting, and distribution. *See* SEL art. 28.

the two countries. Japan adopts more formalistic criteria. Until 1992 the SEL defined a public offering with two basic notions: (1) an offer is made to "many and unspecific persons," and (2) an offer has uniform terms. An interpretive release promulgated by the MOF declared that an offer was made to "many and unspecific persons" if the number of offerees was about fifty or more. In practice, the MOF's release was interpreted to provide a definitive criterion of fifty or more persons.

Finally, the fourth difference between U.S. and Japanese securities laws is that, again until 1992, by employing the notion of a security, the SEL linked its investor protection rules to article 65 of the SEL (a rule similar to the U.S. Glass-Steagall Act). Article 65 essentially prohibits banks (and insurance companies) from engaging in the securities business, except for government and public securities.[9] This regulatory structure was known as the "one-set structure" in Japan and was (and still is) the key to understanding past developments in the regulation of new financial instruments in Japan. If a financial product is a security as defined by the SEL, investors enjoy the protection of the SEL, while banks are prohibited from handling such a product. Further, article 43 of the SEL prohibits securities companies from handling a product other than a security unless they obtain special permission from the MOF. If a product is not a security, banks may handle it, while securities companies may not. In this situation, investors receive no protection from the SEL.

In response to the long battle between the banking and securities industries, the MOF placed priority on the issue of which industry handles each new product over the issue of investor protection. For example, the MOF adopted a policy of allowing both banks and securities companies to handle commercial paper. The securities companies received special permission to handle commercial paper under article 43 of the SEL.[10] Meanwhile, the banking industry successfully persuaded the MOF to exclude securities companies from intermediary services for residential mortgage trusts and securitized bank loans. Thus, the MOF treated these instruments as nonsecurities, which banks may handle under the SEL.

The above approach resulted in the absence of legal protection for investors. To remedy this situation, the MOF took two actions. First, it had special legislation enacted to protect investors. For example, *teitoshoken*, or a mortgage deed, is

9. Although SEL art. 65 is modeled on the U.S. Glass-Steagall Act, the two laws have important differences. For instance, under the SEL, banks (and insurance companies) are permitted to hold shares of other companies for investment purposes. The Anti-Monopoly Law, however, prohibits banks from holding more than 5% of the outstanding shares of any company with very narrow exceptions. For insurance companies, this limitation is 10%. *See* Anti-Monopoly Law (Law No. 54 of 1947, as amended) art. 11.

10. For a detailed analysis of the introduction of the commercial paper market both in Japan and the United States, 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 (1990).

in this category. Second, by rule or administrative guidance, the MOF mandated that banks (and securities companies, with respect to commercial paper) not sell such products having a unit value of less than one hundred million yen. The purpose of this limitation was to prevent the sale of such products to the general public, which was said to need protection by the securities law. Commercial paper and residential mortgage trusts were in this category. The certificate of deposit was (and still is) also in this category, but the "minimum unit rule" has been liberalized for this instrument.

The SEL's narrow definition of "security" was strongly criticized by commentators. As noted above, the MOF took two actions concerning nonsecurities to protect investors. New legislation, however, has enormous costs. For example, hundreds of new statutes must be passed and no new financial product may be sold until corresponding legislation is enacted. The "minimum unit rule" disqualifies new financial products from potential sale to small investors, thereby hindering the development of secondary markets and raising initial financing costs. In short, in Japan many "nonsecurity securities" awaited fundamental reform of the SEL. In this context, the Fundamental Research Committee of the Securities and Exchange Council at the Securities Bureau of the MOF considered a complete overhaul of the SEL since 1988.[11] As a result, important amendments were made in 1992.

II. Recent Developments

A. Prior to 1991

The SEL has been frequently amended in the past several years. In 1988 three amendments were made. First, disclosure requirements were liberalized. Following the reform in the United States in the early 1980s, disclosure requirements in primary and secondary markets were integrated. Reporting companies are now entitled to issue additional new securities by filing a simplified registration statement with the MOF. Also, "shelf registration" became available for certain eligible companies.

Second, regulation of insider trading was strengthened. This amendment included the introduction of new criminal sanctions and the revival of the reporting requirement for the sale or purchase of securities by insiders. These changes should help to enforce liabilities for short-swing profits.

Third, a legal framework for stock-index and other securities-related futures and options was established. As a result, such futures and options are currently traded on the Tokyo Stock Exchange and other stock exchanges. In this connection, new legislation, the Financial Futures Transaction Law,[12] was passed to

11. *See* SECURITIES AND EXCHANGE COUNCIL, HOW BASIC SYSTEM REGARDING CAPITAL MARKET OUGHT TO BE REFORMED (1991).
12. Law No. 77 of 1988.

introduce currency and interest rate futures and options. Under this statute, the Tokyo Financial Futures Exchange was organized for the trading of such derivatives. This dual legal system of financial derivatives is a reflection of the battle between the banking and securities industries. Moreover, commodity futures are regulated by another law, the Commodity Exchange Law,[13] and are traded on commodity exchanges. Thus, three different statutes govern three different sets of exchanges for securities-related futures and options, currency and interest rate futures and options, and commodity futures, respectively.

In 1990 two amendments to the SEL were made with respect to corporate takeovers. First, "the 5 percent rule," similar to section 13(d) of the U.S. Securities Exchange Act of 1934, was introduced. Under that rule, anyone who acquires more than 5 percent of the total issued shares of a public company is obliged to disclose certain information. Second, the rules on stock tender offers were liberalized and became somewhat similar to those under the current U.S. 1934 Act.

The MOF also revised the rules on disclosure under the SEL, now requiring increased disclosure in three important areas. First, a public company is required to make periodic disclosure on a segment basis. Second, a public company is required to add to its financial statements information on both the market value of the marketable securities it holds and on the unsettled positions it holds with regard to futures and options transactions. Third, more detailed disclosure is now required on certain transactions within, and with respect to, corporate groups, or *keiretsu*.

In 1991, as a result of the scandal in the securities industry, two amendments were made to the SEL. First, compensation by a brokerage firm to its customer for trading losses resulting from stock price declines is now explicitly prohibited, with criminal sanctions applicable to both brokerage firms and customers. Second, setting up a discretionary investment account at a brokerage firm, an action that was found to be the major source for such a compensation scheme, is also now prohibited.

B. Reform of the Financial System in 1992

Fundamental liberalization of the Japanese financial system has been underway. Following deregulation in various matters in the financial services area, the most notable of which was to lift the interest rate regulation on bank deposits, heated discussion focused on fundamental changes of the basic legal and regulatory frameworks for the Japanese financial services markets. The basic idea behind the reform was to encourage increased competition among intermediaries in the financial services area by reducing the existing barriers between various fragmented banking and securities industries.

13. Law No. 239 of 1950, as amended.

The Diet passed two bills in 1992 to amend the Banking Law, the SEL, and related statutes. The new regime came into effect on April 1, 1993. The amendments include the following important changes.

1. *Liberalization of Fragmented Markets*

The new regime liberalized the policy that had fragmented the banking market in Japan.[14] First, the specialized bank system was liberalized. More specifically, a bank in one category is now permitted to enter another category's market through subsidiaries. For instance, an ordinary bank is permitted to establish a subsidiary that engages in certain types of trust business.

Second, a bank in one category is now permitted to merge, or be merged, into another bank in a different category. A bank in one category is also permitted to be reorganized as a bank in a different category. For example, a long-term credit bank is permitted to merge with, or be reorganized into, an ordinary bank.

Third, the barrier between the banking and securities industries was reduced. For instance, a bank is now permitted to establish a subsidiary that engages in certain types of securities activities. At the same time, a fire wall must be set up between a parent bank and its securities subsidiary. As for foreign entry, the "50 percent rule" was abolished.[15]

2. *Amendments to the SEL*

The amendment of 1992 effected some fundamental reforms of the SEL. First, the definition of "security" was expanded, and section 1 of article 2 of the SEL was amended to include the following:

(8) a promissory note issued by a corporation for funding for its business, as designated by MOF regulation;
(9) [same as item 8 of the old SEL];
(10) a security or certificate issued by a foreign corporation, which represents a beneficiary trust interest or similar interest in loans by a bank or any other lending institution, as designated by MOF regulation.

Commercial paper was designated as a security under item (8) above. Securitized credit card receivables organized in the United States, known as CARDS, were designated as securities under item (10) above. Either of these instruments could have been designated as a security prior to the amendment, but, as mentioned previously, no such designations were made under item (9) of the old SEL.

In addition, the catch-all provision of the current SEL, item (9), was replaced by the following: "(11) any other security or certificate designated by cabinet order as necessary to ensure the public interest or investor protection, with consideration given to its transferability and other conditions."

14. For details, see MAXIMILIAN J. B. HALL, BANKING REGULATION AND SUPERVISION: A COMPARATIVE STUDY OF THE U.K., U.S.A., AND JAPAN (1993).
15. For a discussion of foreign entry, see *infra* part II.B.3.

While this new provision is more narrowly defined than the old catch-all provision, the MOF will likely rely upon it to designate new securities.[16] The new provision permits the MOF to have any other "paperized," that is, certificated, instrument designated as a security under item (11), unless the transferability of the instrument is restricted or, for instance, the instrument is governed by a different statute concerning investor protection (typically administered by a different ministry).

Section 2 of article 2 of the SEL was amended to expand the definition of a "deemed" security to include not only a right that, in principle, is expected to be paperized (though it may not actually be certificated), but also a right that is not, in principle, expected to be paperized, if such right falls within one of the following three categories:

(1) A beneficial trust interest in loans by a bank, trust company, or any other financial institution or any other lending institution that provides long-term credit for housing (including land or an interest in land for housing), as designated by cabinet order;

(2) a right in a foreign corporation that has the characteristics of a right in (1); and

(3) any other monetary claim designated by cabinet order as similar in transferability to a security listed in section 1, as necessary to ensure the public interest or investor protection, with consideration given to the similarity in economic characteristics to any security listed in section 1, and other conditions.

A beneficial interest in a residential mortgage trust was designated as a security by cabinet order. In addition, the MOF is now empowered to have any right or interest designated as a security by cabinet order if the right is a monetary claim. To designate the right as a security it is necessary to ensure the public interest or investor protection, with consideration given to the transferability of the right and other conditions. The amendments to the definition of "security" were shaped by compromises reached among the ministries, particularly between the MOF and the Ministry of International Trade and Industry.

Second, the rules on private placements were amended. An exemption from disclosure requirements is now available when securities are issued to certain "qualified institutional investors," even if the number of offerees reaches fifty or more. Also, an intermediary activity (*toriatsukai*) involving a private placement is now recognized as a distinctive type of the securities business, and banks (and insurance companies) are usually given special authorization to engage in this service.

Finally, the Securities Trading Surveillance Committee (*Shokentorihikito Kanshiiinkai*) was established at the MOF on July 20, 1992, for the effective

16. The certificate of deposit issued outside Japan was designated as a security under this provision.

enforcement of the SEL because of the 1991 scandals in the securities industry and in other areas. This committee is independent of other bureaus, such as the Securities Bureau, and has strong powers for investigation, search, and seizure with court permission.[17] Also, the scope of antifraud rules, including regulation of insider trading, was extended so as to cover trades in over-the-counter markets.

3. *Foreign Entry*

The regulation of foreign institutions for entry to Japan is pertinent to this discussion.

a. Entry to the Banking Business

The Banking Law in Japan[18] permits foreign banks to engage in the banking business in Japan under the Banking Law through subsidiaries, branches, and other forms. Foreign banks must obtain a banking license from the MOF for each subsidiary or branch in accordance with articles 4 and 47 of the Banking Law. Until 1992 the MOF maintained a strict policy of fragmentation within domestic banking businesses—ordinary banking, long-term credit banking, foreign exchange banking, and trust banking—and the separation of banking and securities businesses. For foreign institutions, however, the "50 percent rule" permitted a foreign investment bank to establish a banking affiliate somewhere outside Japan and establish the affiliate's branch in Japan if the investment bank did not own more than half of the affiliate's outstanding shares.

b. Entry to the Securities Business

Under the Foreign Securities Firms Law[19] a license must be obtained from the MOF when foreign securities firms enter the Japanese capital market through subsidiaries or branches. The 50 percent rule was again applicable. A foreign banking institution could set up a securities affiliate outside Japan and enter the Japanese securities market through branching, if it did not own more than 50 percent of the outstanding shares of the affiliate.

The most well-known exception to the licensing requirement for broker-dealer activities was (and still is) that a license is not required when a foreign broker-dealer transacts with certain specified institutional investors in Japan or executes securities transactions (with no solicitation) with or on behalf of any investor in Japan, if it acts from outside Japan.

c. The New Regime

The 1992 amendments brought into force in Japan a new legal and regulatory framework for financial services. Of immediate importance is the liberalization

17. *See* Curtis J. Milhaupt, *Managing the Market: The Ministry of Finance and Securities Regulation in Japan*, 30 STAN. J. INT'L L. 423 (1994).
18. Law No. 59 of 1981, as amended.
19. Law No. 5 of 1971, as amended.

of the separation of banking and securities businesses. Specifically, a bank is now permitted to establish a subsidiary that engages in the securities business, and a securities firm may set up a banking subsidiary. Also, a trust subsidiary may be established by a bank or securities firm. At the same time, these parent and subsidiary companies are subject to various "fire wall" regulations designed to prevent conflict of interest problems and to accomplish other policy goals.

The 50 percent rule was abolished for foreign institutions in the sense that any foreign institution now may apply for a license in the form of a subsidiary or branch in the banking or securities sector. A twist, however, is that if the same foreign institution enters both the banking and securities sectors in Japan, both companies are subject to fire-wall regulations. But if the foreign institution complies with the 50 percent rule, fire-wall regulations do not apply between its banking and securities entities. Thus, if observing fire-wall regulations is costly, indirect entry under the 50 percent rule can be chosen.[20]

C. 1994 Amendments: Stock Repurchase

The Commercial Code was amended in 1994 to permit a corporation to repurchase its own shares under certain (still restrictive) conditions. In response, the SEL was also amended in 1994 to provide disclosure and antifraud rules in connection with a company's repurchase of its own shares.

D. Future Prospects

1. *Pooled Investment Funds*

The discussion of an overhaul of the regulation of investment trusts or mutual funds is underway. A study group established at the MOF published an important report in June 1994,[21] and the MOF announced extensive deregulation in December 1994.[22] This area is expected to experience considerable change for years to come.

2. *Accounting Rules*

Discussion of the harmonization of accounting rules by the International Accounting Standard Committee encouraged debate about whether Japan should change its domestic accounting rules. While a major change is not be expected, some revisions may occur in the coming years.

20. For an interesting study of the activities of foreign financial institutions in Japan, see J. Robert Brown, Opening Japan's Financial Markets (1994).

21. Study Council on Investment Trusts, Proposals for Reform of Japan's Investment Trust System—In Order to Enhance Their Expected Functions and Roles (1994).

22. *See* 1 World Sec. L. Rep. 17 (1995).

3. *Bond Clearance and Settlement System*

The system of clearance and settlement of bonds and debentures in Japan is unique. The so-called registered bond system creates uncertificated bonds, but over one hundred banks serve as register institutions and, unlike the United States, Japan has no centralized clearing institution. The securities industry has been advocating the introduction of a book-entry system with a centralized clearing institution. However, this proposal met with strong opposition from the banking industry. The future in this area is unpredictable.

4. *General Deregulation Trend*

The MOF, under the new non-LDP government, announced a variety of deregulation measures in September and December 1993. As a result, for instance, new types of bonds (such as adjustable rate bonds and five-year term notes) were issued. Also, eligibility standards for bond issuance, which prevented the expansion of bond markets in Japan, were liberalized in 1993. Further liberalization is expected in 1995.

III. Characteristics of Regulation and Practice

A. Regulatory Characteristics[23]

Although the notion of a security under the SEL was extended in 1992, the scope of the SEL is still limited. In addition to this limitation, other elements also can be identified as unique regulatory characteristics of Japan.

1. *No Rule Means Prohibition*

An important customary rule exists in the financial services area in Japan; that is, the nonexistence of an explicit legal rule endorsing a certain activity under explicit regulatory conditions is understood to mean that such activity is prohibited. When no explicit rule exists as to whether a particular new instrument, such as a negotiable certificate representing the beneficial interest of a trust (other than a loan trust or securities investment trust), is treated as a security under the SEL, or if the rules are unclear, institutions do not create and market such instruments. Put differently, until a consensus is reached on a financial device, followed by a lengthy process for establishing an explicit rule or administrative guideline, virtually no institution will create or market such a financial instrument.

2. *Lack of Litigation*

Little litigation involving new financial instruments occurs in Japan. Relevant parties participate in the administrative rulemaking and legislative processes.

23. This article does not attempt to offer explanations for the elements identified here. For such explanations, see Kanda, *Politics, supra* note 1.

Once an accord is reached, such an accord is unlikely to be challenged before a court. When a dispute is resolved by introducing new legislation, it may be difficult and costly to attack such legislation judicially. Likewise, judicial challenges against administrative rulemaking are rare.

3. *Formalism*

The MOF's rules and guidelines under the SEL are formal. The legal norm for a particular activity or conduct consists of complex formal rules. As described earlier, in the context of differentiating between a public offering and a private placement, the term "many and unspecific persons" that until recently existed was interpreted to be fifty or more persons, irrespective of whether the offerees could fend for themselves. The "minimum unit rule" for certain "nonsecurity securities" is simply one hundred million yen. Under the SEL, the determination as to whether units of a nonsecurities investment fund are treated as securities depends on the legal form of the fund. If the fund is organized as a corporation, the units are securities; however, if the fund is organized in the trust form, the units are not securities.

B. Political Elements

1. *Political Power of the Banking Industry*

Unlike in the United States, in Japan the banking industry has relatively strong political power. Until recently it also enjoyed a relatively good reputation. In past years, banks were successful in discouraging industrial firms from going directly to capital markets for cheaper funds. Long-term credit banks issued bank debentures to the general public and transferred the proceeds to their customer firms in the form of lending. Trust banks sold their special products called "loan trusts" and provided the proceeds to their customer firms as traditional loans. The banking industry prevented the liberalization of bond markets by installing various customary requirements that were imposed on business firms wanting to issue bonds. Whenever new financial products were created or imported from outside Japan, the banking industry successfully persuaded the MOF to locate these new products outside the definition of "security" under the SEL; the banks thus obtained the intermediary business for such products.

As capital markets became international and Japanese firms began to issue bonds outside Japan, the importance of direct finance, such as bond issuance, in the domestic market was widely recognized. At the same time, the importance of investor protection was also recognized, and the SEL was to be amended to accomplish this task. Under these circumstances, the banking industry successfully obtained a path to the securities business. Under the new regime of 1992, banks are now permitted to establish a securities subsidiary. Thus, the increased protection of investors by the SEL and the liberalization of the bond market has been effected in exchange for the recognition of the securities business to banks.

2. *The MOF's Policy: Industry Fragmentation and "No Failure"*

The MOF controls a significant part of finance in Japan.[24] Traditionally, the MOF maintained its power by adopting two important policies: industry fragmentation and "no failure." The financial services industry was fragmented into many subindustries and regulated separately. This fragmentation led in turn to market fragmentation. Thus, the specialized bank system emerged. Trust business was regulated independently. Banking and securities businesses were kept separate. Also, the "no failure" policy was adopted as a price for the MOF's strong regulatory power. This system has worked quite well since World War II. The MOF has allowed virtually no new domestic bank entry since World War II, nor has virtually any new domestic securities firm been licensed during the period. In addition, there has been no bank payoff.

As deregulation became an international trend, the MOF realized the importance of competition in financial services and decided to liberalize market fragmentation. However, the ministry seems to pursue this policy without giving up industry fragmentation. Thus, the future success of the Japanese financial services market seems to depend upon whether fragmented industries can compete in the liberalized market place. Also, the no-failure policy is difficult to maintain once the market becomes highly competitive. The question is how the MOF will maintain its power under the changing circumstances.

3. *Battles Among Ministries*

Another important element that shapes the regulatory landscape in Japan the battle among ministries in the legislative and administrative rule-making processes. A strong competitor with the MOF is the Ministry of International Trade and Industry (MITI). With support of trading companies and leasing companies, the MITI attempted to introduce a market for commodity futures funds in 1990. The original draft prepared by the MITI faced strong opposition from the MOF, and the resulting legislation was a compromise between both ministries.[25] In 1992 the MITI strongly opposed the MOF's proposed extension of the definition of security under the SEL. The resulting new definition was narrower than the MOF had originally contemplated. Also, the MITI attempted to introduce new legislation that would enable leasing companies and finance companies to securitize their asset portfolio. These attempts encountered strong opposition from the MOF. Again, the resulting legislation was a compromise. In short, recent legislation cannot be well understood unless one looks at the battle among relevant ministries in the drafting process.

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24. The word "control" needs careful qualifications. *See* FRANCES M. ROSENBLUTH, FINANCIAL POLITICS IN CONTEMPORARY JAPAN 17-49 (1989) and sources cited therein.

25. *See* Kanda, *Politics, supra* note 1.

C. Market Characteristics

1. *Market and Industry Fragmentation*

Market fragmentation exists within and across the MOF's jurisdiction. Traditionally, the money generated in Japanese capital markets went only to large companies, such as Toyota, for long-term investment. Medium and small companies did not have access to the capital market; nor did individuals such as residential mortgage borrowers. Also, short-term corporate finance was always covered by bank loans. As a result of high economic growth, too much money was generated in the capital market, and there was no place for the excess money to go, except to large companies. Thus, such money flooded out of Japan and moved overseas. Many thought that money generated in the capital market was "efficient" money and that limiting access to such money only to large companies would be both unfair and inefficient. In fact, smaller companies, on average, were obtaining funds at a relatively high cost. Consequently, many people came to think that there should be a route for smaller companies to have access to the money in the capital market.

It is somewhat difficult to explain and evaluate why this traditional characteristic of the Japanese financial market emerged and continued to exist in the way described above. Another characteristic also should be mentioned; bureaucrats controlled the whole picture in Japan and were supported by regulated private sectors. Because of the division in power among various ministries, routes of finance were divided and managed independently from one another. For example, residential mortgages enjoyed a special subsidy through the favorable tax treatment of interest payments. This favorable treatment was driven by the Ministry of Construction. Construction of railroads sometimes enjoyed special funding with favorable terms of finance because of efforts by the Ministry of Transportation. Many think today that excess money generated in the capital market would go to every domestic area if routes were prepared by the government.

2. *Nonexistence of Asset Finance*

Another notable characteristic in the Japanese financial and capital markets is the absence of asset finance. Lenders lend money on the basis of the creditworthiness of a borrower, not the borrower's assets. This lack of asset-based lending may prevent the development of asset securitization in Japan for years to come.

3. *Internationalization*

Capital markets are becoming international. As such, it is no surprise that Japanese firms can easily go outside Japan and issue bonds if doing so domestically is costly. Indeed, Japanese firms have done so extensively. Trading and leasing companies tried to market structured investment funds organized and managed outside Japan to Japanese investors, and pushed the MITI to introduce legislation in this area. The companies wanted the MITI to lift the "no rule means prohibition'' rule by introducing new legislation; in effect, they wanted deregulation by being explicitly regulated.

D. Implications

While deregulation in the financial services area is a worldwide trend and probably an irreversible one, it is difficult to evaluate precisely the present and future regulation in Japan. This difficulty results simply because regulation is a complex reflection of its political and historical landscapes. The strong political power of the banking industry may well mean that increased transactions in Japanese capital markets in the future will accompany increased involvement of banks in their intermediary services. The powerful MOF will try to maintain its power in controlling financial services industries. Its future success may well depend upon whether the MOF can keep pace with today's trend toward a more competitive market environment without destroying industry fragmentation, which would reduce the MOF's controlling power over the industries under its jurisdiction. If financial firms start failing in Japan, the effects are unknown. Even asset-based finance, which has been completely unfamiliar to the Japanese, may well emerge when Japanese firms learn such a new financing mode outside Japan.

As capital markets become internationalized, the traditional regulatory environment in Japan may gradually change. These changes may arise in response to differences in the regulatory environments of various countries. Such differences might prevent worldwide capital market activities and place a country that has a unique regulatory environment in an unfavorable competitive position. The increased need for regulatory cooperation in the international financial services area, such as in the enforcement of insider trading regulation, may influence the Japanese regulators toward a more universal standard in administering and enforcing their policies.

IV. Conclusion

The regulatory environment for Japanese capital markets, like that in other countries, is complex and difficult to understand in isolation; it is historically and politically contingent. The worldwide trend toward deregulation and increased competition among intermediaries had a great impact on Japanese developments both in regulation and practice during the past years. The new regime brought by the amendments in 1992 perhaps includes an inevitable change in response to this worldwide trend. Nevertheless, it is difficult to predict when, and how rapidly, the Japanese regulatory environment will change to the point at which Japanese elements of regulation and practice become indistinguishable from other international forms.

Perhaps it is fair to say that every reform in capital market regulation in Japan continues to be led by the MOF and sometimes other ministries. It is, however, the market place, rather than the government, that produces demand for continuous change in the regulatory environment as new financial products emerge. Thus, the recent developments, taken as a whole, may be an indication of a longer-term trend that Japanese capital markets will ultimately become demand-driven rather than government-driven. Here, the fundamental change of the governmental role in the Japanese capital market is the key issue. Once various financial technologies (such as securitization) used in capital markets are properly identified, capital markets function in an efficient way only when new instruments or securities are created, handled, and sold under market-based mechanisms. These new instruments do not fit in segmental government regulation. Viewed this way, a fundamental change of the regulatory environment must occur in Japanese capital markets.