Reforming Japan's Capital Markets

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Abstract

The Japanese version of the Big Bang announced in November 1996 was a major plan to drastically reform the financial and capital markets in Japan through significant revisions to laws such as the Securities and Exchange Law. The Japanese Big Bang was planned because of mounting worries about the lowering of the international status of Japanese markets and deadlock of the existing financial structure which depended excessively on indirect financing, mainly of bank loans.

The Japanese Big Bang was supposed to have been completed by the end of March, 2001, but in reality system reforms for financial and capital markets are still continuing including revisions of the Securities and Exchange Law and of the taxation system of securities. Reform of the financial structure -- the goal of Big Bang -- has not made notable progress, an example being that most privately held financial assets are still in the form of deposits, because of the following reasons.

The first reason is that participation of individual investors in the security market has not significantly increased. This is due to lack of familiarity with security companies that broker investments in securities and lack of knowledge of the market and investments.

The second reason is that the use of financial and capital markets to procure funds is being hindered by the irrational behavior of banks, an example of which is the placement of loans at interest rates which are not commensurate with the risks involved. This is particularly problematic. It is necessary to reveal the values of securities in the trading market to the maximum extent and to promote conversion of bank credit into securities in order to normalize the behavior of banks. To bring this about it is necessary to strengthen supervision to prevent unjust behavior in the market in order to raise investor confidence in the market.

As a consequence of the Japanese Big Bang and subsequent reforms, the financial and capital market systems of Japan now bear comparison with those in the UK and the US, at least procedurally. However, the system reforms implemented in Japan may just become a state of tilling the ground and failing to sow if there is no change in the attitude of control that experts (including the managing authorities who design the systems) persist in maintaining and no change in the way of thinking of companies that regard procurement of funds in the market as merely being the means to make adjustments for bank borrowing.

I. Japan's "Big Bang" and the Reforms Since

In November 1996 the then Prime Minister, Ryutaro Hashimoto, announced Japan's "Big Bang" program, aimed at solving the country's bad debt problem and reestablishing its financial markets on a par with those in New York and London by 2001, with the motto "Free, Fair and Global." Following the publication in June 1997 of reports by three advisory panels (the Securities and Exchange Council, the Financial System Research Committee and the Insurance Council), the program was largely incorporated in the Financial System Reform Law, which was enacted in June 1998 and came into effect in December of the same year. This comprehensive piece of legislation amended 24 related laws, including most sections of the Securities and Exchange Law and the Securities Investment Trust Law.

As its name suggests, Japan's Big Bang was modeled on the stock market reforms carried out in the United Kingdom 10 years earlier in 1986. There were two main reasons for the timing of the Japanese reform program.

First, there was a growing sense of crisis in Japan at the way the country's financial markets were losing their international status. In 1989 the Tokyo Stock Exchange overtook the New York Stock Exchange as the world's biggest stock market in terms of capitalization and trading volume. However, when Japan's boom of the late 1980s turned to bust in the early 1990s and the United States experienced a boom in information technology, the tables were turned. The position of Japan's financial markets was further undermined by developments such as an increase in the trading of Japanese equities on the London Stock Exchange and in the trading of Nikkei 225 futures on Singapore's SIMEX as well as the continued departure of foreign companies from the Foreign Section of the Tokyo Stock Exchange .[1)]

Although it is a moot question whether these developments were really symptomatic of a decline in the international status of Japan's financial markets, there is no doubt that they added to the pressure in Japan to do something to reverse the decline. It is interesting to note that the pressure for reform in the United Kingdom 10 years earlier was also partly the result of the loss of business to New York and the rapid growth of Tokyo as a financial center. Both Big Bangs were motivated largely by the desire to enhance the status of London and Tokyo as international financial centers.

The second main reason for the timing of the Japanese reform program was the realization that Japanese business had become handicapped by its traditional (over)reliance on "indirect" financing (i.e., bank lending). The system by which surplus money flowed from Japanese households via banks, the postal savings system and insurance companies to the cash-hungry corporate sector (both directly and via state owned financial institutions such as Japan Development Bank) had served the country well for many years. However, the banks found

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[1)] Yasuyuki Fuchita and Sadakazu Osaki, Japan's Securities Markets: The Real "Hollowing Out" Problem , *NRI Quarterly*, Vol.3 No.4, 1994.

themselves being increasingly deserted by their larger corporate customers, who had managed to build up their equity capital, and faced a mountain of bad debt when the property bubble burst leaving them with collateral worth less than their loans. As a result, they were no longer able to provide anything like enough capital for new businesses. The realization that Japan needed to radically reform its capital markets in order to make it easier for companies to raise capital by issuing shares and bonds (i.e., by means of “direct” financing) was a response to this situation. It is important to understand that the program to reform Japan's capital markets and the program to solve the country's bad debt problem were seen as inextricably linked.

However, as the reform program was implemented, the first of the two main driving forces behind it (i.e., the desire to restore the international status of the country's financial markets) gradually receded into the background while the second (i.e., the desire to redirect the flow of money in the economy) began to take center stage. Indeed, this trend is even more apparent in the various reforms that have followed the enactment of the Financial System Reform Law.

The first example of this is the May 2000 amendments to the Securities and Exchange Law, as a result of which stock exchanges were allowed to be for-profit corporations as well as traditional mutually owned membership organizations. The process by which a stock exchange could demutualize was also mapped out. And the Investment Trust Law was amended to enable new financial products such as real estate investment trusts (REITs) to be developed. These amendments were very much a tidying-up operation in the wake of Big Bang. Once Big Bang ended the ban on proprietary trading systems (or alternative trading systems), it was perhaps inevitable that the ban on for-profit stock exchanges should also be lifted. However, memories of pre-war days, when the for-profit nature of Japan's stock exchanges only exacerbated the speculative excesses of the system of forward dealing, ensured that the 1998 amendments stopped short of allowing demutualization. Similarly, the sheer volume of legislation involved in introducing (corporation-type) investment trusts meant that it proved impossible to include real estate investment trusts in the Big Bang program even though there had been calls for their introduction for some time.

This was followed in August 2001 by the Financial Services Agency's Program for Structural Reform of Japan's Securities Markets. From this point onwards it becomes increasingly clear that the capital market reforms that began with Japan's Big Bang were seen as helping to achieve one major historical goal: redirecting the flow of money in the economy. Born of a painful awareness of how retail investors had abandoned Japan's stock markets, the Structural Reform Program aimed to make them the key players on these markets (e.g., by establishing an institutional framework to restore public confidence, encouraging investment trust companies to provide more user-friendly products and promoting investor education) in the hope that this would help to correct the heavy weighting of retail investors' portfolios towards bank deposits.

The reform of income taxation related with securities transactions in Japan, which began in earnest in June 2001 with the introduction of a capital gains allowance for long-term equity

investors, should also be seen in this context.

Although there were calls at one stage for one-off tax concessions, critics pointed out that limited concessions would prove counterproductive as they would only make the tax system more complicated. In the end it was decided to carry out a radical overhaul of the system of securities taxation with effect from 2003. As a result, capital gains and dividends from equity investments will be taxed at only 10% until 2008, and any capital losses can be carried forward for three years. Although the tax system has since been “tightened up” inasmuch as equity investors must now pay tax on their actual capital gains and are no longer able to elect to pay tax on a fixed percentage (2.5%) of the proceeds of a transaction instead, the fact that the tax rate has been slashed and the tax return form considerably simplified means that this has not deterred equity investors. The aim of all these tax reforms has been to treat securities investment in general and equity investment in particular more favorably than they have been treated in the past in comparison with traditional bank accounts—even at the risk of being accused of “favoring the well-off”—in the hope that this will induce a switch out of savings accounts into the stock market.

One document that is noteworthy for the decisiveness with which it called for reform of Japan's capital markets at this time in order to redirect the flow of money in the economy is the July 2002 report “A Blueprint for Japan's Financial System and Public Administration” produced by a special advisory panel to the Minister for Financial Services.[2] As well as pointing out the limitations of Japan's traditional industry-based financial model and the need for a more market-oriented system that will redirect the flow of money in the economy, the report makes a number of recommendations about the role the regulators can play in bringing this about.

A month later, in August 2002, a Program for Expediting Reform of Japan's Securities Markets was announced as a follow-up to the Structural Reform Program of the previous year and as a basis for more detailed discussion by the Financial System Council and the drafting of amendments to existing laws. The following year, 2003, saw even more radical reforms such as the introduction of a system of “securities intermediaries” (i.e., stockbroker agents) and the go-ahead for foreign stock exchanges to install trading terminals in Japan. Finally, the last year 2004, has seen the enactment of amendments to the Securities and Exchange Law that will, among other things, make issue prospectuses more effective, allow banks to act as agents for stockbrokers, abolish Article 37 of the Securities and Exchange Law (which requires any stockbroker wishing to execute an order to buy or sell listed shares off the exchange to obtain the express permission of the investor concerned in advance), require stockbrokers to execute orders on the best terms for their clients, and impose fines for irregular trading activity and inadequate disclosure.

[2] Shoichi Royama (ed.), “Kin'yu Shisutemu to Gyosei no Shorai Bijon” [A Blueprint for the Future of Japan's Financial System and Financial Administration], Zaikei Shohosha, 2002.

II. How Can the Flow of Money Be Redirected?

II. 1. Encouraging more participation by retail investors

Japan's capital markets are therefore still in the throes of reform despite the fact that a program as radical as Big Bang was acclaimed to be has been “implemented in full.” Nevertheless, the bulk of Japanese personal financial assets are still held in the form of bank deposits. Although the economy has recovered and the banks are better able to act as lenders now that they have disposed of the bulk of their nonperforming loans, there is still no sign of any significant switch to “direct” financing. A more market-oriented financial system still seems a pipe dream.

It is often argued that one of the main reasons for the lack of more tangible progress is the failure to encourage many more retail investors to invest in securities.[3)]

This is partly because stockbrokers—perhaps because they have not tried hard enough—have traditionally been perceived in Japan as less accessible than banks and have failed to establish a reputation as investment advisers. It is also partly the result of the simple fact that stockbrokers have fewer outlets in Japan than banks. One of the reasons why, in 2003, a “securities intermediary” system was introduced whereby companies other than stockbrokers are allowed to act on behalf of stockbrokers (e.g., by helping customers to open securities trading accounts and offering them investment advice) was to increase stockbrokers' sales channels and make it easier for the man in the street to invest in securities. The decision since then to allow banks and other financial institutions to act as securities intermediaries was also motivated by the desire to create sales channels for stockbrokers that were perceived as more accessible by the man in the street.[4)]

Another reason often given for the failure to encourage many more retail investors to invest in securities is a general lack of understanding of the role of securities markets and the various approaches and techniques available to investors.

This is particularly noticeable if one compares the situation in Japan with that in the United States, where the market plays a much more important role in the financial system. Following the collapse of Enron in November 2000, the United States was visited by a series of unprecedented corporate accounting scandals. However, with the full support of President Bush as head of state and with the cooperation of the Congress, the Sarbanes-Oxley Act and a number of other laws were passed in record time to deal with the problem. The swiftness of the response can be explained by the widely held view that America's capital markets are an important public good and a bastion of its economy.

In Japan, on the other hand, while there is a widespread understanding of the public nature

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3) However, according to figures on share ownership from the Japanese stock exchanges, the percentage of shares owned by individual investors, which (in money terms) had continued to decline for most of the post-war period, rose for three years in succession after bottoming at 18.0% at the end of March 2000 and stood at 20.6% at the end of March 2003. It would therefore be inaccurate to say that individual investors in Japan have “deserted the market.”

4) Sadakazu Osaki, “Japanese Banks Enter Into Securities Intermediary Service,” Capital Research Journal, Spring 2004.

and social significance of the country's banks, its capital markets in general and the stock market in particular tend to be disdainfully seen as a means of personal enrichment rather than a public institution. A good, albeit minor, example of this difference in attitude is the fact that the symbols used in maps and learnt by children at primary school include one for a bank as well as ones for a police station and a fire station but not ones for a stockbroker or a stock exchange. Not only does this illustrate how banks are viewed as a public institution in Japan but also just how much more familiar they are.

Improving investor education and fostering an awareness of the important role played by capital markets in the financial system (and, by extension, the national economy) are just as essential if more retail investors are to invest in securities as diversifying stockbrokers' sales channels is.

II. 2. Need for banks to behave more normally and to make greater use of securitization

Another reason for the lack of success in redirecting the flow of money in Japan lies with the banks, as the institutions responsible for “indirect” financing, rather than either the stock exchanges or stockbrokers. In a nutshell, the banks need to behave more normally.

It goes without saying that this means that the banks need to dispose of their nonperforming loans, which are still a millstone round their necks, before they can be given a clean bill of health and win back the confidence of the nation. Also, once the financial system has been stabilized, the blanket guarantee on bank deposits needs to be ended as planned in April 2005. Nor is that all. Once they have disposed of their nonperforming loans, banks should not revert to their old ways of blindly competing for corporate lending business and the bank deposits to finance this. Instead, they should seek new profit opportunities in the country's capital markets alongside other participants. Otherwise, they will only create another bad debt mountain to threaten the financial system.

This is because Japan's corporate sector has become a surplus unit, in terms of money flow, and is expected to remain in surplus for at least the next 10 years. This means that, even if the banks try to create more lending business, they cannot expect any significant increase in the demand for capital.[5] Also, even though bank lending as a percentage of GDP has declined after doubling from 50% to 100% during the boom of the late 1980s, it is still higher than in the United States and some other countries. In other words, even if we ignore the question whether Japan has too many banks, there is no doubt at all that, in terms of the banks' lending capacity, the country is overbanked and that this is the reason for the excessive competition in the banking sector. It is this overbanking and this excessive competition that have made it impossible for Japanese banks to charge interest rates that reflect the risks they are incurring and thereby deprived them of the

[5] Yasuyuki Fuchita, “Historical Changes in the Flow of Funds in Japan and the Future Direction of Japan's Financial Industry: The Need for the Discipline of Valuation,” Capital Research Journal, Spring 2002.

profit opportunities that might have enabled them to bite the bullet and dispose of their nonperforming loans more quickly.

If, instead of facing up to the facts, the banks do not mend their ways and continue to offer loans aggressively at rates that fail to reflect their risks, borrowers in general and corporate borrowers in particular would be irrational not to rely on such loans, and it is difficult to see why they should make greater use of direct financing in the form, for example, of bonds and commercial paper. Strangely enough, even though banks are not usually considered key capital market players, whether or not Japan's capital markets expand will depend on whether the banks act out of self–interest and seek to increase their profits.

Closely connected with this is the need for more loan securitization so that risk is borne not just by the bank that carries out the initial credit analysis but by a wide range of parties and the price mechanism is allowed to function properly.

Although we have pointed out that, in terms of the economy as a whole, Japan is overbanked, it is also a fact that, at an industry level, the banks have been accused of being reluctant to lend and eager to call in those loans that they have made. This eagerness has been blamed for putting smaller companies out of business and for making Japan's recession only worse, and was one of the reasons why the Tokyo Metropolitan Government even considered setting up a bank of its own. Given the overall downtrend in bank lending, it will be difficult to prevent a situation where banks are never reluctant to lend or eager to recall loans even if their rates always match their risks. What such a situation requires is securitization as a means of linking indirect to direct financing.

There are many different types of securitized products, ranging from syndicated loans to loan participations, which are slightly more liquid, and asset–backed securities with names (such as collateralized loan obligations and collateralized debt obligations) that vary according to the pooled loan assets they use as collateral. What they have in common is the fact that their transparency and efficient pricing mechanisms have been the main reasons for their success. There will be no shortage of investors, especially institutions, both Japanese and non–Japanese, willing to invest their own money, even if it means taking a risk, so long as they know what they are investing in and that the asking price is reasonable.

In the past, legal and technical problems, such as the requirements that had to be satisfied in order to defend a claim on pooled assets such as loans and difficulties in setting up the companies and trusts that serve as vehicles for these assets, were often cited as the reason for the lack of progress in securitization in Japan. However, during the past 10 years considerable progress has been made in establishing the legal and institutional framework needed for securitization.

This is not, of course, to say that there are no unresolved issues (such as how to set up limited liability companies and limited partnerships like those in the United States where the owners or partners are exempt from corporate income tax in spite of their limited liability). Nor is an institutional framework in itself a guarantee of success: as industry practitioners sometimes point out, a system cannot be used if there are not enough people who know how to operate it.

Another problem (and the biggest one facing the industry) is whether the loans and assets that constitute the bricks and mortar of securitized products will be supplied at prices that investors are willing to pay. This will depend on the banks, who are one of the main holders of loans and assets. Another important point is whether, in such a case, investors are given all the information they need.

Once securitization is accepted more widely, banks will have no alternative but to lend on terms that reflect their risk—if only to ensure that they do not incur a loss when the loans are sold. At the same time, investors will compare securitized products with instruments, such as bonds and commercial paper, that borrowers can issue themselves, and will be able to arbitrage between the two. As this pricing mechanism becomes increasingly accepted, not only should a virtuous cycle be formed where the market for securitized products expands even further but the cost of financing should also reflect the risk involved more closely and society's resources should be allocated more appropriately. This will lead to a more market-oriented financial system while still being “indirect financing” in the sense that it will still be the banks that lend the money. Such financing might well be called “market-oriented indirect financing.” Thus, while the banks have already put considerable effort into this by becoming increasingly involved in loan syndication and originating securitized products, this is, hopefully, only a start.[6)]

II. 3. Respecting the role of secondary securities markets

If the banks are to behave more normally and securitize their loans, not only will they have to disclose adequate information about these assets but the prices of the corporate bonds and commercial paper on which these are based (as well as those of the government bonds that serve as a benchmark) will also have to be formed on liquid and efficient markets. Therefore, the price discovery mechanism of Japan's secondary securities markets will have to be utilized to the full if the market for securitized products is to expand.

On the primary market for both new and secondary securities offerings, where issuers and investors trade directly, prices (and not just those of securitized products) are basically formed by direct negotiation between the counterparties. Direct negotiation is not, of course, the only type of price formation possible: it is also possible to conceive of a process where a stockbroker acting as a specialist intermediary uses book building or open tender to reflect the views of a wide range of investors in the direct negotiations.

However, the most reliable and efficient way of discounting a large amount of information in a price is to conduct transactions on a liquid secondary market and to use the price formed there as a point of reference. A good example of this is capital increases at market prices by listed companies.

[6)] The author is indebted to Professor Ken'ya Fujiwara for pointing out some examples of how the market function is underutilized. One such example is the fact that it is not uncommon, in the case of syndicated loans, for there to be more lead managers than co-managers.

Even in the case of financial products (such as corporate bonds) whose secondary market is relatively immature, prices can be formed (i.e., terms fixed) by assuming a spread over government bonds that reflects the creditworthiness of the issuer.

Even in the case of financial products (such as securitized products) where secondary markets are still few and far between, prices can be formed fairly and efficiently by using as a benchmark prices discovered on existing secondary and derivative markets for other securities. In the case of securitized products, prices can be formed using the secondary market for government bonds as a benchmark in the same way as in the case of corporate bonds so long as there is a third-party credit rating. Therefore, while a secondary market is an important price discovery mechanism, this does not mean that there has to be a secondary market for every financial product.[7)] Similarly, even in the case of typical negotiated transactions such as bank loans and private placements, a true and fair price can be set using a spread over a benchmark such as a government bond yield or an interbank rate. Indeed, not even marketability is an absolute condition for using the capital markets' price discovery mechanism.

In other words, secondary securities markets do not exist simply to enable profit-seekers to cash in their securities and take their profits. They also perform a very public role by enabling buyers and sellers to discover the price of financial products, thereby ensuring an efficient flow of money in the economy.

However, we need to realize that, although price information from related markets can be used to derive a price for financial products without any market of their own, the price derived may be neither fair nor efficient if the related markets are small and illiquid, and if either the products traded or the participants trading them lack diversity.

Let us take the example of credit derivatives, trading in which has increased in recent years. Although they enable market participants to price credit risk, it has been pointed out that the borrowers that are the real object of the trading are all major international companies.[8)] 13 This means that it is inappropriate to use the prices formed on credit derivative markets to measure the risk of lending to companies (especially smaller companies) in particular countries or areas. We need to realize that, when we talk about using secondary market prices to reflect market perceptions in negotiated transactions such as bank loans, the scope for this approach is actually quite limited. Therefore, while it may be possible to discover such prices by establishing credit derivative markets for particular geographical areas and sizes of company, limited participation is likely to mean that pricing will be inefficient and costs prohibitive.

However, a more fundamental problem is the fact that in Japan people do not fully appreciate the importance of the role played by secondary securities markets. For example, many of those

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7) This point is frequently misunderstood in Japan. One example of this is the argument that, if you want to issue more junk bonds, you need to establish a “market” (i.e. some sort of exchanges) for that purpose. In fact, so long as prices reflect market conditions, plenty of investors will be willing to invest in such bonds after discounting the effect of their low liquidity, regardless of whether or not they are traded on a large and organized secondary market.

8) The author is indebted to Professor Akiyoshi Horiuchi for pointing this out.

who do acknowledge the importance of the stock market believe strongly that it exists to provide capital to growth companies and that rampant speculation should therefore be discouraged. Underlying this view appears to be the belief that the primary market is the real capital market, that the secondary market exists so that investors in new issues can cash in their investments and that it would be a mistake to try to extend this role. Those who overemphasize the importance of long-term investment on the grounds that equities and investment trusts should be held for the long term probably share this view.

While one can understand why some people disapprove of secondary market volatility caused by short-term traders engaged in a money game, it is actually impossible to draw a hard and fast line between speculation and investment. Unless it is a wash sale (prohibited under the Securities and Exchange Law as “market manipulation”), where there is effectively no exchange of either cash or securities, short-term trading (including short selling) is a perfectly respectable economic activity that contributes to price discovery and market liquidity however it may be labeled.

Let us take the example of short selling, the regulation of which in Japan has been the subject of heated debate and which some people even consider to be a sure but illicit bet. In fact, short selling is a perfectly proper type of transaction based on the view that the current market price is too high. An increase in short selling signals that some investors consider the market overpriced. If they are wrong, they will have to buy back the securities concerned at a higher price and realize a loss. Nobody else loses out.

Basically, anyone who invests in a growth company for the medium to long term is speculating inasmuch as we cannot predict the future with any degree of certainty. If taking a punt for a week or an hour is speculation and therefore reprehensible, taking a punt on what is going to happen to the price of something over a period of 10 years is surely speculation and reprehensible. Securities markets are places where buyers and sellers place short-, medium- and long-term bets on the basis of a wide variety of information and thereby play an important role in price discovery.

In Japan, particularly during the past few years, many people have demanded “action” against share prices that they believed were too low. It is probably simplistic to believe that the price discovery mechanism will always function properly just because there happens to be a stock market or stock exchange somewhere. There will always be different views at any one time about what is a fair share price. However, so long as a market is free of irregular trading activities such as insider trading and manipulation and investors can count on a certain degree of liquidity, it will be very difficult to make the case that the government should intervene in the national interest because the prices on that market are too low.

In the past few years there has been a heated debate in Japan about whether action is needed to revitalize the stock market. Compared with the early 1990s, however, the market's daily turnover ratio (daily trading value ÷ market capitalization) has actually increased. Companies are able to make initial public offerings and rights issues, and it is no longer the case, as it was in 1992, when no initial public offerings were allowed, that companies are unable to raise capital there. Even

when the Nikkei 225 Average declined to the 8,000 level, the stock market was still functioning properly. Perhaps those who demanded action to revitalize the market really only wanted to see share prices higher and were less interested in boosting turnover or increasing efficiency for their own sake.

This is not to say, of course, that a falling stock market is a good thing. Inasmuch as the stock market reflects economic activity, a sustained decline in share prices should be seen as a danger signal for the economy. The only proper action that should be taken to combat low share prices is for companies to convince investors that their strategies and approaches will boost both current and future earnings. Simply setting up a body to control the short-term demand and supply of shares or modifying accounting standards will not help share prices in the medium term. Now that investor confidence has improved, it would be a good time for Japan's financial authorities to reaffirm that their basic policy is to trust the market's own pricing mechanism and to fine-tune economic policy with one eye on any danger signals coming from the market while refraining as much as possible from intervention.

II. 4. Preventing irregular trading activity

In order to ensure that the market pricing mechanism continues to function properly, irregular trading activity needs to be monitored more carefully and investor trust needs to be restored. Japan's Big Bang program is generally credited with having brought about an epoch-making change in the authorities' attitude to regulating the country's securities markets: from one of deterrence to one of detection. This is not to deny that there are those who question whether the current level of monitoring and supervision by the Securities and Exchange Surveillance Commission and the Financial Services Agency is adequate.

Detection is all very well, but it is poor consolation to those who find themselves victims of fraudsters and unscrupulous operators and will only destroy investors' trust in the market. A case in point is that of the Internet operator MTCI, whose premises were searched by agents of the Tokyo Public Prosecutor's Office in November 2002 on suspicion of having submitted a false registration statement when it made a public offering in October 1999. In July 2003 the former chairman of the company was found guilty and sentenced to two years' imprisonment with hard labor by the Tokyo District Court. However, it is difficult to see what can be done to help the victims four years after the company obtained their money on false pretences.

Compared with fraud, which is a criminal offence, violations of the Securities and Exchange Law such as making false entries in registration documents and the failure to send issue prospectuses have more in common with procedural offences and should be easier to detect and prove. Even if detection can only be after the event, the authorities need to step up their monitoring and efforts at detection in order to limit the damage caused by such offences.

It is a well known fact that the US Securities and Exchange Commission makes full use of

enforcement powers (such as civil injunction proceedings and civil penalties) which the Financial Services Agency and the Securities and Exchange Surveillance Commission do not have (or cannot use). Some improvement can be expected in this respect now that the latest (2004) amendments to the Securities and Exchange Law have been enacted enabling civil fines to be imposed for illegal trading activity such as insider dealings and market manipulation. Nevertheless, it should not be forgotten that the extent to which these agencies can use their detection powers also depends very much on the quality of their staff and how they are organized, and that an institutional framework alone is not enough.

III. Reforming Japan's Capital Markets: The Road Ahead

At one time it was possible to identify shortcomings in Japan's capital markets and suggest solutions to them simply by comparing Japan's capital markets with their more advanced counterparts in the United States and the United Kingdom. Some excellent reform programs have been drawn up simply by recommending that systems that existed in the United States and the United Kingdom but not in Japan be introduced while some that existed in Japan but not in the United States and the United Kingdom be abolished. However, since the Big Bang program and the series of reforms that have followed it, Japan's capital markets have undergone a radical change. In many (at least, formal) respects, they can now bear comparison with their US and UK counterparts.

There are, of course, some unresolved issues. The main one is the fact that, under the Securities and Exchange Law and other existing legislation, investor protection in Japan is limited in scope and outdated. The reason for this is that the Securities and Exchange Law defines "(marketable) securities" by listing a limited number of examples. This means that any investors who purchased a new financial product not listed in the Law's definition of "(marketable) securities" would not be fully protected by the Law's provisions.

This issue was confronted once in the course of the debate that accompanied the reforms that followed Big Bang. In the end, all that came of it was an unsatisfactory compromise in the form of the Financial Products Sales Law. The issue was raised once again, in December 2003, when the First Subcommittee of the Financial System Council submitted its report "Towards a Market-Oriented Financial System." The report recommended that a solution be sought independently of the Securities and Exchange Law by enacting an "Investment Services Law." While such a major reform clearly cannot be enacted overnight, progress will hopefully be rapid.

Of the various issues mentioned earlier in this paper, the enactment of an "Investment Services Law" is most closely related to those of encouraging greater participation by retail investors and preventing irregular trading activity. As far as the other issues mentioned earlier are concerned, the need for banks to mend their ways and the need for greater use of securitization have more to do with changing the attitude of market participants than with establishing an institutional

framework and do not lend themselves to discussion under the heading of institutional reform. The same is probably true of the need to establish more secondary markets in securities. The institutional framework within which Japan's secondary markets have to operate is now quite sophisticated. Indeed, now that the latest (2004) amendments to the Securities and Exchange Law have been enacted, it is difficult to identify any serious shortcomings in this framework. If any shortcomings do exist, they are more likely to be found in the basic attitude of those who created and operate the institutional framework or those who participate in and use Japan's securities markets.

Ever since the Securities and Exchange Law was enacted after the Second World War, Japan's capital markets have been based on the US principle that companies should be required to disclose all the information that investors need in order to make their decisions and that investors should therefore take responsibility for those decisions. Trading on Japan's securities markets is unrestricted (unless it involves unfair practices such as fraud, insider dealing or manipulation), and there are no restrictions on who may trade. Similarly, companies and other issuers of securities are supposed to be free of any restrictions on what securities they may issue and offer on the secondary market so long as they satisfy any disclosure requirements.

In fact, however, this freedom is a façade. In reality, the authorities have often imposed regulations that have severely restricted eligibility to issue securities or to purchase particular types of securities.

The most extreme example of this was regulation of the corporate bond market, especially by means of bond issuance standards administered by a group of banks and stockbroking companies acting as trustees and underwriters (the so-called Kisaikai or "Bond Issuance Committee")—a system that was finally abolished in January 1996. A further deterrent was to make the denominations of corporate bonds too large for retail investors. Another example was the so-called "No Return" rule, which, until the mid-1980s, limited the issue amount of private placements to ¥2 billion per issue and prohibited companies that had made a public offering from making a private placement again—all in the name of "fostering the growth of public offerings." Similar restrictions (on issuers and denominations) were imposed for the same reason when the markets for commercial paper and securitized products were established.

Although less restricted than either the corporate bond or the commercial paper market, the stock market was also for many years subject to regulations that were not in keeping with the spirit of the law. One example is the regulation that prohibited companies that failed to satisfy the very demanding listing requirements from offering new shares to the public. As far as the rules of the Securities and Exchange Law are concerned, any company that has filed a registration statement and fulfilled its disclosure obligations may make either primary or secondary share offerings regardless of whether it qualifies for a listing. In fact, the first time that an unlisted Japanese company was allowed to offer new shares to the public was in May 1984, when Sanko registered on the deregulated OTC market. Even then, until 11 years later, in July 1995, when a

second section of the OTC market was established, no loss-making company was allowed to go public even if it had disclosed its loss-making status.

The reason why this discrepancy between the spirit of the law and how the system was actually administered lasted for so long was probably that many of those in authority and many experts were deeply suspicious of the disclosure system that forms the basis of Japan's capital markets, however well they may have understood it in theory. In other words, they probably believed that, no matter how good the disclosure system might be, at the end of the day retail investors would be unable to judge for themselves and that, since the stockbrokers and investment advisors that acted as intermediaries between investors and the market would only try to take advantage of investors, the only proper way to protect investors was to reduce the number of risky investment opportunities available to them.

Today, when it is generally accepted that markets should normally be unrestricted, such views are seldom aired in public. In fact, however, many people are probably still sympathetic to such views even in the post-Big Bang world. The "action" that many people have demanded in recent years against share prices that they believed were too low (see above) almost certainly reflected an authoritarian desire to justify arbitrary intervention against the workings of the market.

Although many of the restrictive regulations that were imposed on Japan's capital markets in the past were imposed in the name of "investor protection," the effect was only to limit the options available to companies looking to raise capital and to deprive investors of a wide range of investment opportunities. Until the 1990s Japanese investors generally had only an extremely limited range of securities (mainly government bonds and listed stocks) to choose from. It is therefore hardly surprising that their portfolios were heavily weighted towards postal and bank savings accounts. For their part, Japanese companies had no alternative but to rely on bank loans, thereby ensuring the continuing dominance of indirect financing. Whether or not future reforms of Japan's capital markets succeed in making the financial system more market-oriented will depend partly on whether the experts and those in authority are really able to discard their authoritarian ways of thinking.

It will also depend on the attitude of the companies that depend more than anyone else on the capital markets for their funds.

Ever since the 1980s big Japanese companies have endeavored to improve their competitiveness, their credit ratings and their brand recognition; but they have also sought to reduce their reliance on bank loans. This has enabled them to free themselves from the trammels of being constantly monitored by their bank. Their main means of achieving this has been to use the Eurobond market and the Japanese stock market as alternative sources of finance. Not only have these attempts to diversify been quite successful: they have also led the banks to lend at rates well below the market rate in order to hold onto their big corporate clients. As we saw earlier, this is one of the reasons why Japanese lending rates have long failed to reflect the true degree of risk incurred.

In accepting such favorable loan conditions, big Japanese companies have sometimes been

blinded by short–term gain and ignored their need to diversify their sources of funding in the medium to long term. One example of this is Japan's commercial paper market, which should be an alternative to bank loans for working capital. Such has been the variation in issue amounts as a result of interest rate volatility that the market has been unable to expand steadily. Similarly, the Japanese corporate bond market, which, until recently, had been growing while bank lending marked time, has actually started to contract now that the banks' nonperforming loans have begun to decline. This shows that companies are using the capital markets as a means of adapting to changes in bank lending rates.

In the United States, on the other hand, most big companies have an ongoing commercial paper issuance program that enables them to obtain funds from a wide range of investors regardless of any changes in bank lending rates. One of their reasons for this is that they believe that having a wide range of sources and methods of finance is essential to their risk management if they are to have ready access to working capital.

This is not, of course, to say that big US companies think they can do without banks. For big companies with an ongoing commercial paper issuance program banks can offer back–up credit when choppy conditions on the commercial paper market make refunding difficult. In addition, they perform a vital daily role as links in the payments system.

Even though it is more than three years since Japan's Big Bang program was fully implemented and the country's capital markets appear to have a comprehensive institutional framework, the desired effect will not be achieved unless those in authority discard their authoritarian ways of thinking and companies adopt a different attitude. To use a well worn saying, it might be said of Japan's capital markets that, although the field has been ploughed, there is still a risk that the farmer may forget to sow the seed.

References

In addition to the literature referred to in the text, readers may wish to refer to the following:

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