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Japan's Experience in Opening Up its Capital Markets

An example of market liberalization for emerging nations

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Summary

- This report provides a short history of the opening up of Japan's capital markets and market liberalization during the postwar period. The report was produced with China in mind as progress is made in the liberalization of that country's capital markets, but with the expected opening up of financial markets in other emerging nations, as well as their streamlining and liberalization progresses, we believe that Japan's experience in this area can offer many helpful suggestions.

- Major milestones in the opening up of Japan's capital markets are as follows: (1) The gradual liberalization of Japan's capital markets during the 1960s and early 1970s (inward direct investment, internal and external securities investment), (2) Open membership in the Tokyo Stock Exchange touched off by the US-Japan Yen-Dollar Committee during the 1980s, (3) Growth in number of foreign-owned securities companies entering the Japanese market due to passage of the Act Concerning Foreign Securities Companies in 1971, and (4) Establishment of bond issuance market and derivative market in the latter part of the 1980s.

- The liberalization of capital markets can be thought of as a necessary measure to strengthen the competitiveness of both corporations and capital markets through the promotion of competition. In the case of Japan, the major impetus for opening up its capital markets was pressure from foreign governments. However, since this established the basis for the globalization of the capital markets which would arrive later, it was also beneficial to domestic corporations. Even with the reform of the legal system there are still cases where some foreign companies are unable to enter Japan's market. Obscure regulations and the existence of customary practices have been indicated as the reason that this occurs. Japan's experience with this issue suggests that various regulations and customary practices should also be reviewed simultaneously as the entry of foreign companies into domestic markets expands.

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1. Overview

This report provides a short history of the opening up of Japan's capital markets and market liberalization during the postwar period. The report was produced with China in mind as progress is made in the liberalization of that country's capital markets, but with the expected opening up of financial markets in other emerging nations, as well as their streamlining and liberalization progresses, we believe that Japan's experience in this area can offer many helpful suggestions.

During the years following WWII Japan strictly limited both internal and external capital transactions, then during the 1960s gradually liberalized its capital markets. The first step in the liberalization of capital transactions came in 1964 when Japan became a member of the OECD. Then in 1980, the revision of the Foreign Exchange and Foreign Trade Control Act (referred to below as the Foreign Exchange Act) fundamentally transformed the system so that it was now based on the principle of free trade. In 1984, Japan began moving toward a comprehensive opening up of its markets touched off by the US-Japan Yen-Dollar Committee. Finally, during the 1990s, across-the-board reform of the financial system was carried out referred to as "Japan's Big Bang". Although pressure from foreign governments can be pointed out as having been key to the opening up of Japan's markets to foreign participation, it has also acted as a driving force in progress in the liberalization of Japan's domestic capital markets as well as the strengthening of Japan's international competitiveness.

Major milestones in the opening up of Japan's capital markets are as follows: (1) The gradual liberalization of Japan's capital markets during the 1960s and early 1970s (inward direct investment, internal and external securities investment), (2) Open membership in the Tokyo Stock Exchange touched off by the US-Japan Yen-Dollar Committee during the 1980s, (3) Growth in number of foreign-owned securities companies entering the Japanese market due to passage of the Act Concerning Foreign Securities Companies in 1971, and (4) Establishment of bond issuance market and derivative market in the latter part of the 1980s.

1.1 The Liberalization of Capital and Restrictions on Foreign Investment

1.1.1 Effects of Liberalization of Capital

After the initial stage of liberalization in 1967, inward direct investment was expanded in stages to include a broader range of industries. With the exception of a few industries, 100% liberalization was reached by 1973. In the early stages, expansion of the amount of inward direct investment was not so noticeable. During the 1970s, inward direct investment was no more than Y50 bil annually, but major expansion occurred during the 1980s after the revision of the Foreign Exchange Act. In 1990 inward direct investment exceeded Y400 bil.

As for inward securities investment, the Bank of Japan introduced an automatic approval system in 1952. Then in 1980, the revision of the Foreign Exchange Act allowed approval to be obtained with advance application alone. Before this, the annual net amount had been around Y500 bil, but after 1980, it exceeded Y1 tril, indicating the extent to which capital inflows and outflows had increased by that time. As for stockholdings in Japan, there was a large number of loyal shareholders in the domestic market by around the middle of the 1990s. It was the latter part of the 1990s that the number of foreign investors holding Japanese stock shares grew noticeably.

The liberalization of external securities investment lagged somewhat behind that of inward securities investment. The process began in 1970 when the allowable amount in foreign investment was set at a maximum of US$1 tril (on a balance basis). Said investments would be carried out through securities investment funds handled by investment trust companies with investments flowing to blue chip stocks listed on eight major overseas stock exchanges including New York and London. After this point liberalization continued in stages until 1980, when the revision of the Foreign Exchange Act the free flow of investment capital to take place. There were also regulations which institutional investors had to follow regarding stock and flow, but these were relaxed in stages as a result of the 1985 Plaza Accord, which led to the rapid appreciation of the yen. On the flow side of the equation, investment in foreign securities totaled around Y1 tril annually (net) in 1980, but then after 1985 it exceeded Y10 tril each year for a period of five years.

Risk also increased along with expanding inward and outward investment in securities. Japan was now much more effected by fluctuations on the world's stock markets. Meanwhile, the ratio of transactions on the part of foreign investors in Japan's domestic markets also increased, and as they did, the correlation between the domestic and foreign stock markets also increased. Events overseas could now lead to increased volatility and rapid capital inflows and outflows even in the domestic financial and capital markets. This required the development of daily trading limits and short-selling regulations on Japan's domestic stock market.

1.1.2 Restrictions on Foreign Investment

As the liberalization of capital progressed, rules restricting foreign investment in certain industries were introduced. Application of these new restrictions focused on areas such as national security, public infrastructure management, universal service, and producer protection. Restrictions usually came in the form of the enforcement of policies or measures which foreign corporations could not conform to, such as individual business laws (special regulations related to particular industries). In other cases, the fact of government ownership of certain industries kept foreign investment out.

Restrictions on foreign investment were implemented through individual business laws such as the following: The Mining Act, the Nippon Telegraph and Telephone Corporation law, the Radio Act, the Broadcast Act, the Marine Act, the Civil Aeronautics Law, and the Consigned Freight Forwarding Business Act. Meanwhile, situations in which government ownership was imposed included Nippon Telegraph and Telephone (over 1/3 ownership) and Japan Tobacco (also over 1/3 ownership). By holding majority voting rights, the government could block any extraordinary resolutions that might be brought up at the shareholders meeting, such as changes to the articles of incorporation, corporate dissolution, or mergers. As recently as 2013, the largest shareholder of Seibu Holdings, US investment firm Cerberus Capital Management, proposed that some of Seibu Railway's lines be discontinued, but the question of whether measures ensuring public interest in accordance with the Railway Business Law would take effect in this instance became an issue. In the end, Cerberus withdrew its proposal when the stock market recovered and so provisions in accordance with the Railway Business Law did not come into play.

1.2 Open Membership in the Tokyo Stock Exchange Touched Off by the US-Japan Yen-Dollar Committee

Open membership in the Tokyo Stock Exchange (TSE)

In terms of official policy, foreign-owned securities companies obtained the right to become members of the Tokyo Stock Exchange in 1971 when the Securities and Exchange Act was revised, but actual membership only became possible when the articles of incorporation of the TSE were revised in 1982. Even then, the maximum number of members allowable remained fixed, hence in reality it was still not possible to gain membership. Finally, the issue was taken up by the US-Japan Yen-Dollar Committee in 1984. At the time, the US Secretary of the Treasury was Donald Regan, former Chairman of Merrill Lynch, hence he was especially concerned about this problem. He made a direct request to the Minister of Finance at that time, Noboru Takeshita, to consider expanding the number of members allowable on the Tokyo Stock Exchange. The decision to increase the number of members on TSE was finally made in 1985, and memberships were granted to six foreign-owned securities companies. Another 16 foreign-owned companies gained membership in 1987, with three more added in 1990.

The New York Stock Exchange opened its membership to foreign-owned securities companies in 1977 and the US subsidiaries of Japan's major securities companies gained membership at the beginning of the 1980s (Nomura Securities in 1981 and Daiwa Securities in 1982). Part of Treasury Secretary Regan's argument for the Tokyo Stock Exchange accepting foreign-owned securities companies as members was of course that the New York Stock Exchange had already done so.

Behind the TSE's decision to finally expand its membership so as to include foreign-owned securities companies was the fear that Japanese companies, which had begun expanding into overseas markets, might be treated unfavorably. Gradually the Japanese authorities began to realize that with Japanese companies entering overseas markets, they would have to reciprocate by opening up Japan's own market.

Opening up membership brought an increase in foreigners investing in Japan's stock market, and now the TSE would have to respond to their demands. One of these was the speeding up of the trading system itself. However, this also meant that when problems occurred in the system, the affects were much large than before. How to minimize the risk of this occurring now became an issue.

1.3 Foreign-Owned Securities Companies Enter Japan's Market

1.3.1 Background and Effects of the Entry of Foreign Firms into Japan's Market

The biggest increase in the number of foreign-owned securities companies entering Japan's market occurred during the 1980s, and by 1990 all of the world's major firms had established themselves in Japan. The year 1985 when foreign banks were first allowed to operate a securities business is especially notable due to the sharp increase in the number of universal banks establishing branch offices in Tokyo. (Branch offices of subsidiaries of foreign securities firms with 50% capitalization or less were granted licensing.)

Merrill Lynch Japan was the first Japanese subsidiary of a foreign securities firm to be established, having inherited a portion of the branches and employees of Yamaichi Securities, which had voluntarily closed its business in 1998. Even after this development most foreign firms tended to enter the Japan market by virtue of opening up branch offices. But in 2006, in response to a revision in Japan's corporate law, Goldman Sachs, Credit Suisse, Deutsche Securities and others, who until then had operated branch offices, officially established Japanese subsidiaries.

The easing of regulations brought an increase in the number of foreign-owned securities companies entering Japan's market. It was mostly the wholesale departments of Japanese securities companies that were negatively influenced by this development, since their share of corporate bond underwriting decreased.

There are a variety of things which one can say the Japanese securities market itself has benefited from as a result of the entry of foreign capital into the market. For the market in general and for the middleman, there has been more efficient price formation, while a more diverse population of investors entering the market has brought a broader range of opportunities for revenue growth due to the introduction of new methods of trade. Meanwhile, for issuing companies, there are a number of benefits, one of which is the ability to procure capital in overseas markets without any of the problems which used to be associated with that activity. On the other hand, there are a few disadvantages as well. One is the outflow of income to other countries, while another is unstable employment in the financial industry due to the shorter business cycle of foreign firms in comparison to Japanese corporations, which also means the possibility of restructuring or even the sudden decision to pull out of the market. The entry into the market of traders who seek excessive profitability could even upset the stability of the market overall. Additionally, once the entry of foreign capital into the market has progressed, linkage with overseas markets becomes much closer, meaning that risk increases that the domestic market will be negatively affected if there is a global financial crisis. Meanwhile, close linkage with world markets could in some cases reduce the attractiveness of the market to some investors due to the reduction in arbitrage opportunities.

1.3.2 Changes in Approach to the Monitoring of Foreign-Owned Securities Companies

Up until the 1990s, the financial and securities regulatory apparatus in Japan usually took the form of administrative guidance. However, under this system almost no foreign firm ever underwent an inspection. The foreign firms were more or less left to their own devices. During the era when there were very few foreign securities firms in Japan, this fact seemed to have a limited effect on the administrative guidance system. This apparently resulted in a certain slackness as far as the actual carrying out of inspections at foreign firms. Hence, there was little to motivate foreign firms to set up their own in-house compliance systems.

During the latter half of the 1990s when the effects of the bursting of Japan's economic bubble were at their largest, there was a sudden turnaround in this tendency and detailed inspections of foreign firms were carried out one after another, often including administrative guidance procedures. In 1999, the bank license of Credit Suisse First Boston Group was revoked due to the sale of financial products which involved the covering up of its clients' actual financial condition. Then in 2002, ten foreign-owned securities companies were ordered to suspend business due to violations of regulations on short-selling. In 2004 Citibank's business license was suspended. The reason for these tough administrative guidance decisions was that the focus of financial supervision had shifted from the protection of domestic financial institutions to protection of the market. It is also a reflection of how the inspection system itself, whether dealing with domestic or foreign-owned companies, had been strengthened, as well as the result of improvements in fairness and transparency.

1.4 Further Development of the Market and Growing Influence

1.4.1 Yen-Denominated Foreign Bonds (Samurai Bonds) and Eurobonds

Public offerings of yen-denominated foreign bonds (samurai bonds) began in 1970 and private placements began in 1972. The issuance of Euroyen bonds came a bit later in 1977 when non-resident issues were accepted. In 1985 issuance by residents began. At first, it was thought best to give Euroyen bonds a merely complementary role with the raising of yen capital by non-residents concentrated mostly in samurai bonds. However, regulations regarding Euroyen bonds were rapidly eased after the US-Japan Yen-Dollar Committee was formed 1984.

This resulted in a rapid increase in Euroyen bond issue amounts, but at the same time brought on a decline in the domestic corporate bond market. The main factor behind this development was the fact that requirements for the issuance of bonds (issue standards, financial restrictions, etc.) were stricter on the domestic market than on the Euroyen bond market, making it difficult to issue bonds quickly and flexibly. In addition, the principle of competition (i.e. the market mechanism) did not work sufficiently well enough in Japan's domestic corporate bond market due to the mechanism and customary practices used in bond issuances, including coordination of bond issues and the trustee system. Looking back now, it can be said that it would have helped to coordinate market liberalization in both markets, going at the same pace in the Euroyen bond market and in the domestic market.

It was the US-Japan Yen-Dollar Committee which demanded that foreign-owned corporations be allowed to enter the underwriting business as lead managers in this new international bond issue market. Foreign-owned securities companies obtained the right to act as underwriter and lead manager on non-resident Euroyen bonds as of 1984, and then on resident Euroyen bonds in 1987. The underwriting share of foreign firms grew after that point, but at the same time, underwriting commission rates declined.

1.4.2 The Derivatives Market

The postwar Securities and Exchange Act did not originally recognize futures trade, but during the 1980s as the liberalization and internationalization of the capital markets progressed, the trading of bond futures began after revision of the Securities and Exchange Act in 1985. Then in 1988, a further revision of the Securities and Exchange Act brought TOPIX futures trading to Japan, while at the same time futures trade also began on the Nikkei 225.

Eventually, the Securities and Exchange Act accepted financial futures and options trading in interest rates and currencies. Trade began on the Tokyo Financial Futures market (originally the Tokyo Financial Market) in 1989.

One of the benefits of introducing a derivatives market is that trading by foreign investors effectively utilizing derivatives gives a welcome boost to trade volume even during periods when stock prices are on the decline. On the other hand, there is also criticism in financial circles that aggressive use of derivatives can cause increased market volatility.

One approach would of course be a more gradual implementation of a derivatives market, allowing domestic financial institutions more time to prepare themselves for dealing with this new type of market. However, overseas markets could become the focus of this kind of trade during such a wait period. Moreover, there are other important factors involved in the cultivation and development of a derivatives market, including building a low-cost, flexible system which can handle the introduction of new products in an agile fashion, and bringing more flexibility to regulations and customary practice, one of these being the diversification of currencies used in trade settlements. In Japan’s case, differences of opinion between ministries and industries, as well as the issue of the time and cost required to introduce new products, has caused a decline in the international standing of its derivatives market. Over half of trade in derivatives in Japan is associated with the Nikkei 225, TOPIX, and long-term government bonds. On the CME, the leading derivatives market of international importance, the process of trial and error by which new products are introduced is performed in a flexible manner, allowing the market diversify the types of products it handles over the years.

1.5 What Japan’s Experience Suggests

The liberalization of capital is considered to have been a necessary measure to strengthen the competitiveness of Japan’s corporations and capital markets by virtue of promoting competition. In the case of Japan, the major motivating force in opening its markets was pressure from overseas. However, being that this provided the basis for the globalization of its capital markets, it also provided benefits for domestic corporations. But despite the liberalization of the legal framework, there were still cases where foreign-owned companies were unable to enter Japan’s market. The existence of regulations and customary practices which remained opaque are often pointed out as being the reason. Japan has a history of reviewing and readjusting regulations and customary practices in the form of responding to specific, concrete demands regarding specific areas (some would say forced to by US and European interests), and one typical example is the opening up of membership in the Tokyo Stock Exchange. Continuous and progressive review of regulations and customary practices is important in increasing the number of foreign-owned firms entering the market.

In carrying out the liberalization of capital in Japan, there was the highly advanced capital protection systems of cross-shareholding ties between former zaibatsu-type industrial groups. Along with the Japanese style main bank system, this type of business conglomerate is often considered to have been important as a means of maintaining management stability when Japan was still at the stage of economic development. However, once Japan’s economy had matured, it became more important to attain a level of transparency in corporate governance so that globalization could progress, making it necessary to change this Japanese style structure. In modern times, countries advancing toward the liberalization of capital are expected by the international community to have a high level of transparency in corporate governance. In order to avoid overly rapid change, a process in which appropriately changing regulations associated with foreign-owned capital is carried out in stages should be considered.

The entry of foreign-owned securities companies can lead to more efficient price formation on the market through the stimulation of arbitrage trades, program trading, and trading of derivatives. Moreover, more diverse investors, such as hedge funds, will be encouraged to become participants. However, in Japan, along with the increase in the ratio of foreign-owned companies came an increase in linkage with the US stock market, and entry of foreign-owned companies into the market has meant the possibility that market volatility could also increase. This is another factor which one must be on guard against. Meanwhile, the entry of foreign-owned underwriters and investment banks with selling power leads to smoother capital procurement on overseas markets, as well as activating more M&A deals in both the domestic market and overseas.

Once liberalization and opening up takes place, competition will heat up and a shakeout could occur amongst domestic securities companies. Competitiveness of the securities industry overall will likely be strengthened, but caution is also required so that domestic investors do not become unprofitable in the shakeout process.

Development of a bond issuance market is also important as liberalization and the opening up of the market progresses. It is considered to be desirable to develop a healthy international bond issuance market which is easy to use by overseas participants. This includes the cultivation of an offshore market and a foreign bond market with bonds denominated in one’s own country’s currency.

With active underwriting taking place by foreign-owned companies on an international bond issuance market, there is a possibility that commission rates could decline due to the promotion of competition. This benefits the issuing firm in that it becomes easier to procure funds. However, in Japan, liberalization of brokerage commissions was progressing at the same time as the bond issuance market. This meant that domestic securities companies which depended on brokerage commissions were forced to quickly change their business models. These changes require supervision and guidance so as to avoid instability in the securities industry overall.

2. An Account of Japan's Opening Up to Foreign Business

2.1 OECD Membership Leads to Opening to Foreign Business in 1970s

After WWII, Japan's foreign exchange control was established in accordance with the "Foreign Exchange and Foreign Trade Control Act" made public in December 1949. At first, the law stated that "foreign transactions are prohibited in principle" and said principle was upheld until 1980 when the law was completely revised, at which point the above passage was changed to "foreign transactions are free in principle" (in other words allowed), and since then, this new principle has been upheld. In addition, a special act was appended to the "Foreign Exchange and Foreign Trade Control Act" called the "Law on Foreign Capital" made public in May 1950, requiring permission in advance for a foreigner to become a shareholder of stock in a Japanese company.

2.1.1 The Opening Up of Inward Direct Investment in Stages

Japan gradually changed this framework whereby foreign transactions were prohibited in order to gain acceptance as a member of the international community. One of the factors leading to this change was joining the IMF8 in April 1964, as well as membership in the OECD occurring around the same time. Along with membership in the OECD came the obligation to lift restrictions on the migration of capital in accordance with the "Agreement regarding liberalization of the migration of capital." Liberalization gradually progressed, with inward direct investment following in 1967.

In the first phase of Japan's liberalization in July 1967, as regards inward direct investment, foreign ownership of up to 100% was automatically approved for 17 industries and up to 50% for another 33 industries. In the second phase of liberalization in March 1969, foreign ownership of up to 100% was automatically approved for 44 industries and up to 50% for another 160 industries. Phase 3 implemented in September 1970 then saw a major increase in the number of industries in which 100% foreign ownership was automatically approved (up to 100% in 77 industries and up to 50% in 447 industries). Phase 4 of liberalization was implemented in August 1971 at which time up to 100% foreign ownership was automatically approved in a total of 228 industries and up to 50% ownership in all other industries with the exception of 7 industries which still required case-by-case screening (in other words these 7 industries were not liberalized).

Liberalization was rolled out gradually as described above and then in 1972 as a part of its foreign trade policy, the government made the decision to proactively move toward the promotion of liberalization of capital. As a result, as of May 1973, the government began to move toward 100% liberalization in principle of inward direct investment. With the exception of 5 industries (agriculture, forestry and fisheries, mining, oil, leather and manufacture of leather products, and retailing with more than 11 outlets), the establishment of new companies with up to 100% foreign ownership was given automatic approval. Five industries were made exceptions and remained closed to foreign ownership for reasons ranging from agricultural policy to the protection of resources and policies protecting small business. As for the retailing industry, 100% liberalization was implemented in June 1975.

2.1.2 Inward Investment in Securities

A policy granting automatic approval for inward investment in securities, in other words the acquisition of stocks, equity interest, and beneficiary certificates for the purpose of investment or asset management, as well as the acquisition of corporate bonds, was established even before the Phase 1 liberalization of 1967, and proceeded in parallel with developments in inward investment in other areas. The Phase 1 liberalization saw the maximum shareholding ratio allowable for foreign investors grow from 5% to 7%, while the maximum ratio of foreign ownership of a corporation grew from less than 15% to less than 20%. The maximum approval limit for the ratio of foreign ownership of a corporation grew again as of Phase 3 of liberalization when it was raised to 25% or less. As of Phase 4 of liberalization, the maximum shareholding ratio allowable for foreign investors was raised to 10%.

As for beneficiary certificates and corporate bonds, approval or licensing from the Ministry of Finance was required by law, but with the exception of private placements, the approval and licensing procedure was delegated to the Bank of Japan, which then gave automatic approval.

2.1.3 The Impact of Liberalizing Inward Direct Investment

Along with progress in the liberalization of inward direct investment and inward securities investment came the fear that there was now an increased risk of foreign corporations acquiring Japanese domestic corporations. As a result, many domestic corporations began to work behind the scenes to acquire stable shareholders. Cross-shareholding or interlocking shareholding within the same corporate group became common amongst the former zaibatsu conglomerates. Another approach that became common was cross-shareholding between a business corporation and a financial institution. The shareholding ratio on the part of business corporations in companies listed on the stock exchange nationwide grew from 18.4% in 1965 to 27.5% in 1973, growth of 9.1% pt. During this same period, the shareholding ratio on the part of financial institutions (minus investment trusts) grew from 23.3% to 33.8%, or growth of 10.5% pt. During the same period, the shareholding ratio of foreign investors grew by only 1.2% pt, from 1.8% to 3.0%.

2.1.4 Foreign Securities Companies Begin Their Advance into the Japanese Market

As for entry of foreign-owned companies into the securities industry, automatic approval of up to 50% ownership was adopted in accordance with the “Foreign Exchange and Foreign Trade Control Act” and the “Law on Foreign Capital” as of Phase 3 of liberalization. Then in 1973 automatic approval of up to 100% ownership was adopted, thereby discontinuing all limitations. However, the granting of licenses to foreign-owned securities companies to open a full-fledged branch office was not yet provided for in the regulations, including in the Securities and Exchange Act. After 1961 only the opening of a representative office was allowed. This was considered to be an undesirable situation from the viewpoint of internationalization, so in 1971, a new law separate from the Securities and Exchange Act was established. This was the “Law on Foreign Securities Firms,” which paved the way for the establishment of branch offices in the Japan domestic market. By 1980, five foreign securities firms had opened branch offices in Japan. The “Law on Foreign Securities Firms” was in use until 2007 when it was folded into the “Financial Instruments and Exchange Law.”

2.1.5 Liberalization of Foreign Securities Investments

After the Second World War, Japan’s foreign currency reserve was tight, and hence foreign securities investments were prohibited across the board. Liberalization was carried out gradually after 1970 during a time when foreign currency reserves had rapidly increased. First, in April 1970, investments in stocks and bonds listed on overseas stock markets totaling up to 100 million dlrs on the part of securities investment trusts was recognized. Then in January 1971, investments in overseas stocks totaling up to 100 million dlrs on the part of insurance companies was recognized. In July of the same year, the limit placed on the total amount in overseas investments allowable for investment trusts and insurance companies was abolished, while at the same time limits were abolished on the amount in foreign stock and bond investments allowable for the ordinary investor. In a continuation of the move toward more liberalization, investments in stocks and bonds listed on overseas stock markets was allowed for securities companies as of November 1971, then trust and banking companies as of February 1972, and in March of the same year authorized foreign exchange banks.

In addition, ordinary investors were allowed to acquire foreign stocks and bonds by investing in overseas investment trusts as of November 1972.

2.1.6 Foreign Stocks Listed on the Tokyo Stock Exchange

The purchase of stocks and bonds listed on overseas stock markets by ordinary investors was liberalized in 1971. However, this was a special system, in which "the actual securities certificate associated with securities purchased is in principle deposited with an overseas custodian, and the investor is issued a deposit certificate by the Japanese securities company."[1] In order for investors to gain the ability of purchasing foreign securities without worries, considerations began in regard to the trading and distribution of foreign securities in domestic Japan. In 1973, the Securities and Exchange Council submitted a report entitled "Streamlining the Securities Related Legal Framework in Light of Internationalization of the Securities Market," in which the council proposed the listing of foreign issues on the domestic stock exchange and entrusting the actual securities certificate to an overseas custodian.

In December of 1973, the Tokyo Stock Exchange established a foreign section, and trading of 6 issues commenced.

2.2 Complete Overhaul of "Foreign Exchange and Foreign Trade Control Act"

Various revisions were made to the "Foreign Exchange and Foreign Trade Control Act" after its original issuance in 1949 in the move toward liberalization. These included abolishing the foreign currency budget system after joining the IMF 8 and discontinuing the foreign currency holding restriction system. However, foreign exchange control was again strengthened temporarily as a result of the oil crisis of 1973, and policy to inhibit capital outflow while encouraging capital inflow was adopted. Policies meant to contain capital outflows included lowering the maximum amount allowable for remittances of small amounts, limiting yen denominated bond issuances by non-residents, and the prohibiting of purchases of foreign short-term government securities and purchase of securities in foreign currency. Meanwhile, policies meant to encourage capital inflows included lifting the ban on domestic corporations issuing foreign-denominated bonds, the introduction of impact loans, and the abolishment of restrictions on non-residents purchasing domestic short-term securities.

Once the effects of the first oil crisis had abated in 1977, the Ministry of Finance simplified foreign exchange control considerably. Limitations on the amount of foreign currency Japanese were allowed to take with them when travelling overseas were abolished as part of a major overall easing of restrictions on foreign trade, while measures were also announced which would simplify capital transactions. This included the abolishment of non-resident deposit accounts, the easing of restrictions on the purchase of short-term securities in foreign currency by residents, the abolishment of restrictions on balances of foreign currency deposit accounts held by residents, and the easing of restrictions on the purchase of overseas real estate.

This series of developments indicates exactly how much Japan had liberalized its foreign exchange control by the end of the 1970s. However, the basic principles according to which the "Foreign Exchange and Foreign Trade Control Act" was originally established, in other words prohibited in principle with liberalization the exception, remained unchanged. This became one of the major factors behind the misunderstanding of the international business community that Japan's market remained closed. Then in January 1978, then Prime-Minister Fukuda indicated that he was moving in the direction of changing the basic principles of the "Foreign Exchange and Foreign Trade Control Act" to liberalized in principle with prohibitions the exception. In later negotiations between Japan and the US and between Japan and the EU, he promised to consider a new system based on the principle of liberalization.

[1] History of Fiscal and Monetary Policies in Japan, pg. 471

The revised version of the “Foreign Exchange and Foreign Trade Control Act” was enacted in December 1979 and enforced as of December 1980. Article 1 of the revised law states that it is “based on the understanding that all foreign exchange transactions, foreign trade and other foreign transactions are to be freely carried out.” The major elements which were revised are listed as follows.

2.2.1 Liberalization of Capital Transactions in Principle and Emergency Regulation

In regard to capital transactions, the revised law allows transactions to take place freely and on a day-to-day basis, the only requirement in the majority of cases being simply to report capital transactions to the Ministry of Finance. In other words, the new framework allows all capital transactions to take place freely with the exception of special cases such as emergencies, which require special authorization. Emergencies (or contingencies) are defined as (1) Situations which could cause difficulty in maintaining the international balance of payments, (2) Situations which could cause sudden or major fluctuations in the yen exchange rate, and (3) Cases in which the amount of funds being transferred is so large that it could have a negative effect on Japan’s financial and capital markets.

Capital transactions covered by the revised law include both inward and outward securities trade, issuance of foreign bonds by Japanese corporations, issuance of domestic Japanese securities by non-residents, and issuance of Euroyen bonds by non-residents on overseas markets.

Capital transactions which do not require reporting to the government include (1) Capital transactions carried out as part of the normal business of an authorized foreign exchange bank, (2) Inward and outward securities investments for the purpose of asset management in which at least one of the interested parties is a designated securities company or brokerage of a designated securities company, and (3) Acquisition of overseas real estate by residents.

2.2.2 Liberalization of Advance Reporting System for Inward Direct Investment

The older version of the “Foreign Exchange and Foreign Trade Control Act” required special approval for introduction of long-term foreign capital and inward securities investment. However, liberalization rendered this requirement unnecessary, and so when the older version of the “Foreign Exchange and Foreign Trade Control Act” was abolished, the system of approval was abolished along with it. In its place, a new system of advance reporting was established in regard to inward securities investments for the purpose of management participation, such as the acquisition of shares in a company, since in some cases this could have a negative effect on the smooth operation of Japan’s economy. If the particular situation is such that negative effects are expected to be especially large, the government will require that the content of said inward securities investment either be changed or cancelled.

The acquisition of shares of companies listed on the Tokyo Stock Exchange for the purpose of asset management is liberalized in principle, but if shareholdings of more than 10% are acquired, said transaction is defined as inward direct investment and requires advance reporting.

2.2.3 Restriction on Holdings of Authorized Foreign Exchange Banks

This is a new regulation introduced in the revised version of the “Foreign Exchange and Foreign Trade Control Act” according to which settlements of all foreign transactions must be carried out through an authorized foreign exchange bank. The purpose of this regulation is to prevent an excessive amount of foreign exchange risk which could make it difficult to uphold international trust, as well as to prevent excessive fluctuations in the yen exchange rate. For this reason there is a restriction on the amount of holdings an authorized foreign exchange bank may carry in foreign currency.

2.3 Background and History of the US-Japan Yen-Dollar Committee

Liberalization of Japan's markets progressed in stages over the years, with measures to liberalize capital transactions implemented in the 1960s and 70s, followed by the shift to "liberalization in principle" in the 1980s with the implementation of the revised Foreign Exchange and Foreign Trade Control Act. Then in May 1984 a report by the US-Japan Yen-Dollar Committee was made public, which led to a shift toward "taking all necessary measures and concretely indicating when and to what degree they could be implemented."[2]

The US-Japan Yen-Dollar Committee was established in November 1983 when former US President Ronald Reagan visited Japan. Agreement to setting up the committee was reached in talks between Reagan and former Prime Minister Nakasone. Behind the decision to form the bilateral committee was increasing US criticism of Japan due to its rapidly expanding trade surplus with the US in the 1980s. Some were of the opinion that the trade surplus was caused by the yen/dollar rate behind which stood the closed nature of Japan's financial and capital markets. Hence it was felt that Japan should liberalize its financial and capital markets while at the same time internationalizing the yen.

After the Japan-US Summit, then Minister of Finance Takeshita and US Treasury Secretary Regan held a joint press conference in which they announced the establishment of a "joint Japan-US *ad-hoc* group on yen-dollar exchange rate, financial and capital market issues" (the US-Japan Yen-Dollar Committee). At the same time, various measures for the liberalization of Japan's financial and capital markets and internationalization of the yen, as well as when said measures would be implemented, were incorporated in the statement. Concretely speaking, this included elimination of the real demand rule in forward exchange transactions (January 1984), the implementation of reform legislation regarding the designated company system (December 1983 National Diet), implementation of legislation regarding the overseas issuance of foreign currency bonds, consideration of the establishment of a yen-denominated banker's acceptance market, and the reduction of issuance units for CDs (January 1984), as well as raising the limit on CD issues (January 1984), easing of issuance guidelines for Euroyen bonds issued by non-residents (January 1984), and consideration of the withholding tax problem in regard to Euroyen bonds.

The working group of the US-Japan Yen-Dollar Committee met six times between February and May 1984 with participation by the Japanese Ministry of Finance and the US Department of the Treasury.

2.3.1 Report of the US-Japan Yen-Dollar Committee

The report of the US-Japan Yen-Dollar Committee made public on May 30, 1984 contained six chapters, including an Introduction, Follow-up to November 1983, The Yen-Dollar Rate Problem, Japan's Concerns, US Concerns, and the Conclusion. However, the report gave most of its weight to US concerns. Rather than a mere follow-up to the joint press conference, the report's focus was on additional measures demanded during the meetings of the working group. The major areas of the US concerns were (1) Liberalization of the financial and capital markets, (2) Securing the ability of foreign financial institutions to access the market, and (3) Liberalization of the Euroyen market from the viewpoint of internationalization of the yen. These points are covered in more detail below.

US Concerns A: Liberalization of the financial and capital markets

First of all, there were several points concerning interest rates. These were (1) Withholding tax on interest income of non-residents, (2) Elimination of limits on interest on time deposits, (3) Change in customary practice as regards short-term government debt, and (4) Dealing in government bonds by foreign banks. The first item listed here was a request to eliminate the withholding tax, which the

[2] Tokyo Stock Exchange 50-Year History Vol. 7, pg. 326

Ministry of Finance was clearly against since it would do harm to the basic principle of the tax scheme. The second item was a demand for liberalization of interest rates. Interest on accounts other than savings deposits had already been liberalized, and a more complete liberalization of interest rates was thought to be unavoidable, so the Japanese government indicated that it would move in that basic direction starting with the liberalization of large deposits. Number three in the above list was a request for an open market of the same kind as the US TB market. In response to this request the Ministry of Finance responded that it had no plans on making any changes to the current system or customary practice. As for number (4) above, dealing in government bonds, approval was granted.

Meanwhile, the question of financing and loans was handled in the same form as concrete financial products and transactions, such as (1) Domestic certificates of deposit (CD), (2) Establishment of a yen-denominated banker's acceptance (BA) market, (3) Yen conversion regulations, and (4) Liberalization of yen-denominated foreign loans. As for (1), the government acknowledged the point and produced a schedule for changes, including the easing of issuance terms for CDs and bringing down the lower limit of the issue period. As for (2), the Japanese government agreed to the improvement and expansion of the short-term financial market and to contribute to the internationalization of the yen. Number (3) pertains to regulations regarding the foreign-denominated debt ceiling when banks convert foreign capital to yen. The government announced that this rule would be abolished with the reasoning that foreign exchange risk will not occur on a swap transaction. The Japanese government also decided to carry out liberalization proactively as regards number (4) listed above.

Other issues were (1) The real demand rule in forward foreign exchange transactions and (2) Accounts held by residents in overseas financial institutions. The purpose of (1) was to prevent speculation in foreign exchange transactions, but instead this rule tended to create a barrier to a corporations attempts to avoid foreign exchange risk, and so was abolished in April 1984. On the other hand, as regards (2), the government refused to grant its recognition, as it would simply create a loophole in regulations controlling outward direct investment, and because the licensing system for banks and securities companies must be upheld.

US Concerns B: Entry of foreign financial institutions into Japan's financial and capital markets

Points were raised as follows regarding access to Japan's financial and capital markets on the part of foreign financial institutions. (1) Foreign securities companies should be allowed to acquire membership on the Tokyo Stock Exchange, (2) Foreign firms should be allowed to manage investment funds in Japan, and (3) Demand for more transparency in Japan's regulatory environment.

Issues surrounding (1) above were as follows. First of all, membership in the TSE is an independently run membership system and hence not subject to government involvement. Furthermore, the system does allow new membership, however, at that time all available seats were filled and this is why foreign securities companies were unable to gain membership. In the end, it was decided that the Minister of Finance would approach the TSE and ask them to come up with some means of resolving the problem. As for (2), put in other terms, what this meant was a demand to allow foreign banks to enter the trust banking business in Japan. At the time there were 8 banks carrying out trust banking in Japan and recognition had not been granted for market entry to any more beyond that, but even so, the government decided to give permission to foreign banks to enter the market. As for (3), it was affirmed that Japan's financial guidance was difficult for foreign financial institutions to understand and that improvement in transparency should be sought out. The Ministry of Finance therefore promised to improve transparency and to speed up processing of applications.

US Concerns C: Development of the Euroyen investment and banking markets

In regard to liberalization of the Euroyen market, the following issues existed. (1) Liberalization of the Euroyen bond market, (2) Participation as lead manager and co-lead manager, (3) The problem of withholding tax on interest acquisition of non-residents, (4) Liberalization of the Euroyen CD market, and (5) Liberalization of Euroyen syndicate loans.

In response to (1), the Japanese government decided to recognize the issuance of Euroyen bonds by non-residents, as well as to ease issuance guidelines on Euroyen bonds issued by residents. Meanwhile on (2), the Ministry of Finance decided to allow foreign securities underwriters to freely participate in the Euroyen bond market. Meanwhile, the Ministry of Finance also announced that it would do away with guidance, limitations, and requirements associated with participation in Euroyen bond issues as lead manager and co-lead manager.

2.3.2 Implementation of Items Included in Report

Japan steadily continued to implement changes, in some cases earlier than originally promised, following the suggestions of the report of the US-Japan Yen-Dollar Committee. In April 1984 yen denominated foreign loans were liberalized and the real demand rule in forward foreign exchange transactions was abolished, while in June of the same year, short-term Euroyen loans to residents were liberalized and regulations regarding yen conversion were abolished. In April 1985 mid to long-term Euroyen loans to non-residents were liberalized and the issuance of Euroyen bonds by residents was recognized. In June of the same year the yen-denominated BA market was inaugurated.

2.3.3 Progress in financial liberalization in consideration of the Yen-Dollar Committee

In July 1985, the Japanese Ministry of Finance announced its “Action Program for the Improvement of Market Access” in which policies were rolled out showing progress in liberalization going beyond the Yen-Dollar Committee. The following subject areas were listed along with concrete schedules for implementation. (1) Liberalization of interest on savings accounts, (2) Establishment of a bond futures market, (3) Streamlining of the domestic bond issuance market, (4) Handling of distribution of yen-denominated BA by securities companies, (5) Entry into the trust banking market by foreign banks, (6) Granting of membership rights in the Tokyo Stock Exchange to foreign firms, and (7) Flexible issuance of Euroyen bonds. As for (1), liberalization was complete for interest on large savings accounts by spring of 1987. As for (2), the bond futures market was inaugurated in October 1985. Then (3) easing of issue standards on unsecured straight bonds was implemented in October 1985, while streamlining of the yen-denominated foreign bond and foreign currency denominated foreign bond markets was also carried out. In April 1986, issue standards on yen-denominated foreign bonds were shifted to a rating system. Then in June 1985 market entry as mentioned in (5) above was granted to all 9 banks which had requested it. Finally, in regard to (6), the Tokyo Stock Exchange decided after consideration to increase the number of regular memberships, and in February 1986, six foreign securities companies gained membership on the TSE.

Meanwhile, an area not touched upon by the Yen-Dollar Committee, the Tokyo Offshore Market was inaugurated in December 1986. This special market was established in order to encourage the Tokyo market’s progress toward becoming an international financial center. Financial trading on this market was to remain separate from the domestic market, applying special measures as regards financial and tax issues.

Later, in June 1987, the Ministry of Finance announced further progress in liberalization based on its publication entitled “The Immediate Outlook for Internationalization of the Financial and Capital Markets.”

2.3.4 The Plaza Accord

Despite the fact that the US-Japan Yen-Dollar Committee had brought up the yen/dollar rate as an issue, the exchange rate was more or less left up to the market mechanism. The main theme of the committee was of course the liberalization and opening up of Japan’s market. However, rather than having an immediate corrective effect on the imbalance in US-Japan trade, the trade imbalance simply grew larger. The US trade deficit grew rapidly and protectionist sentiment grew stronger on the domestic political scene. In March 1985, the senate passed a request for a resolution for retaliatory measures against Japan, and in April of that year the Senate Finance Committee passed a bill for retaliation against Japan.

In response to this situation, the G5 began leaning toward the opinion that an adjustment in the yen rate in the form of a coordinated intervention was required. Then on September 22, 1985, a meeting of the G5 finance ministers and central bank governors was held at the Plaza Hotel in New York, and an agreement was made on said coordinated intervention. This is called The Plaza Accord. Dollar-selling intervention was carried out until the end of October, at which point the yen/dollar rate went from 240 yen to 200 yen, or yen appreciation of just under 20%. Even after the intervention pressure continued leading toward further yen appreciation, until the yen hit 150 yen to the dollar in July 1986. The effect in Japan was what is referred to as the “high-yen recession.”

2.4 Tightening of Regulations and Financial Reform Since Latter Part of 1980s

2.4.1 The Tendency Toward Tightening of Regulations

The shift from the bubble economy of the latter part of the 1980s to the bursting of the bubble in the early 1990s brought on a new tendency tightening regulations in the capital markets. In April 1989 an insider trading regulation was introduced, and since April 1990 a capital requirement was adopted in order to ensure that securities companies would maintain financially sound. Then in October 1991 new articles were added to the revised Securities and Exchange Act, including prohibition of loss compensation and discretionary trading. Additionally, a Securities and Exchange Surveillance Commission was established in July 1992.

2.4.2 Market Participation in Both Banking and Securities

According to Article 65 of the Securities and Exchange Act, participation in the securities business by banks and other financial institutions was originally prohibited. Japan’s Securities and Exchange Act, passed in 1948, was modelled on the US Banking Act of 1933, which established the separation between banking and securities. In the late 1980s the thinking was that the law, especially those aspects of the financial system determining specialization and separation of different aspects of the business, should be reviewed in keeping with recent changes in finance.

The first concrete steps toward a review of the Securities and Exchange Act came in June 1992, followed by implementation of the Financial System Reform Act in April 1993. The new law recognized entry into areas of finance previously separated by virtue of establishing a subsidiary for that purpose. This made it possible for a bank to own subsidiaries doing business in securities and trust banking, and for a securities company to own subsidiaries in the business of banking or trust banking.

At the same time, the system of government guidance by three different ministries was still in existence. This system, first established in 1974, was highly symbolic for issues effecting the banking and securities business. According to the guidance system, when a Japanese corporation issued foreign bonds, a local (in-country) securities subsidiary of a Japanese bank was not allowed to act as lead manager. However, this rule was abolished when the Financial System Reform Act was implemented.

Simultaneous involvement in different aspects of finance became increasingly allowed with the removal of the ban on financial holding companies in December 1997, the introduction of investment trust sales by banks in December 1998, the elimination of restrictions on the business operations of securities subsidiaries owned by banks and other financial institutions in October 1999, and removal of the ban on securities brokerage business operated by banks and other financial institutions in June 2004.

2.4.3 Streamlining the Bond Market

As long as the business operations of banking and securities remained separated, corporate finance remained an activity carried out in an indirect manner. This caused the development of Japan’s bond market to fall behind as a direct means of financing. In order to activate the bond market as a part of financial reform, issue standards required in the past, along with mandatory inclusion of debt restrictions in the financial covenants were abolished in August 1996. Meanwhile, limitations on term to maturity for corporate bonds were also eliminated, making it possible to choose from a variety of terms rather than sticking to the formerly required 7-year term for bond issues. Issuance of bonds in Japan increased as the market became more streamlined, but whereas issuance of corporate bonds increased, the percentage of corporate debt accounted for by bonds did not. The amount of growth in bond issues was insufficient from the viewpoint of building a multi-track financial system.

2.5 1990s Sees Greatest Ever Financial Reform

2.5.1 Japan’s Big Bang

As Japan entered the 1990s its economic bubble burst, leading to a collapse in stock prices and real estate values. The problem of bad debt (non-performing loans) became increasingly serious, and Japan’s economy was in a rut. One of the policies whose purpose was to break the impasse was the idea of full-blown financial reform, and the decision was made to implement said reforms. This is what is known as *Japan’s Big Bang* urged on by then Prime Minister Hashimoto in November 1996. He outlined a reform plan to be complete within five years, saying that “the aim is to revitalize our country’s financial market and to make it an international financial market along the same lines as New York and London by the year 2001, while at the same time promoting the disposal of nonperforming loans.”

The stated principles of this reform were to be that it would be “free” (i.e. the market principle at work is that it is a free or liberalized market), with liberalization of market entry, products and pricing, and that it is “fair” (a transparent market which can be trusted), with rules having clarity and transparency, where investors are protected on a global level (a market which is international and ahead of its times), having a legal framework, accounting system, and auditing framework tailored to globalization. Based on these principles work began to come up with concrete plans for the reform, with responsibilities divided between five committees – one responsible for securities trade, another for foreign exchange, then an investigative committee on the financial system, an insurance committee, and a committee on corporate accounting. Each committee was to submit a public report by June 1997.

2.5.2 Foreign Exchange and Foreign Trade Control Law Drastically Revised for Second Time Since WWII

In advance of Japan’s Big Bang, considerations were being made to drastically revise the Foreign Exchange and Foreign Trade Control Law for the second time since WWII. The findings of the study committee on this question were submitted in January 1997, and the revision was carried out in April 1998.

The revised version of the Foreign Exchange and Foreign Trade Control Law implemented in 1980 already had free trade as its principle, and capital transactions had already been liberalized. However, trades not carried out through an authorized foreign exchange bank or a designated securities company required authorization in advance and submission of a report. Hence it was pointed out that this risked creating a barrier to execution of the trade in a timely manner despite the progressive globalization of the financial markets. In this second drastic revision of the law the following changes were made: (1) The authorized foreign exchange bank and designated securities company systems were abolished, and (2) The requirements of advance authorization and submission of a report were eliminated.

Though it was not the kind of thing that would dramatically transform the market through a complete change of course in policy, this revision provided the finishing touch on the international financial transaction reforms and is considered to be a follow-up to changing the system as the globalization of finance accelerated.

2.5.3 Turnaround in Securities Administration and Promotion of Competition in the Securities Business

The committee on securities trade presented its report in advance of the other committees in November 1996. The title of its report was "Summary of Issues," and indicated a change of direction from the former incremental easing of regulations to drastic market reforms. The report also stated the necessity of proactively eliminating restrictions on products and business operations. As for administrative method, the report advised a switch from prevention to after-the-fact inspections, and mapped out suggested enhancements of the regulatory framework, including a streamlined rules, monitoring and dispensation, associated with disclosure and fair trade.

Following the direction set by this report, many regulatory reforms were implemented within a short period of time. The change having the most impact was the complete liberalization of brokerage commissions in October 1999, and the switch from a licensing system for securities companies to a registration system in December 1998. These developments occurred at the same time use of the internet was spreading, and new entries into the securities business on the part of online brokers was especially active. This also added to competition, which led to the lowering of commissions. After a while the tendency became excessive, with commissions becoming even lower due to competition, and as a result, brokers who also served the function of providing information went out of business. There was also a new tendency to cut back on the number of outlets and employees at securities companies.

2.5.4 Reforms Designed to Meet Investor Needs and Diversification of the Market

As the pool of investors became more diverse, the necessity of providing a supply of various types of products responding to those needs came into consideration. This led to more changes in the regulatory environment, including the introduction of corporate investment trusts in December 1998 and privately placed investment trusts at the same time. Meanwhile, a complete lifting of the ban on securities derivatives was also implemented in December 1998. During this same time sales of investment trusts by banks was introduced, and because of this, sales of investment trusts through banks grew rapidly. The securities transaction tax and the exchange tax were abolished in April 1999.

Another way of responding to investor needs was to set up a form of competition between different markets. In order to do so, the requirement to trade stocks only through a stock exchange was eliminated in December 1998. At the same time, a private trading system (PTS) was also introduced, and securities companies began to carry out arm's length transactions with investors and processing of orders using the PTS since trading could now take place outside the stock exchange. In November 1997 the Tokyo Stock Exchange began an off-auction trading system.

2.5.5 Disclosure and the Fair Trade Rule

Realizing that globalization would require a new kind of accounting system, the corporate accounting committee carried out a review of the consolidated financial statements system in its public report, and recommended considering the introduction of an accounting system based on valuation at market price for financial instruments. As of March 2000, corporate accounting began to focus on the consolidated balance sheet, while in March 2001 mark-to-market accounting was introduced.

In order to handle the diversification of financial products taking place during the switch from regulations based on advance prevention to after-the-fact inspections, it was necessary to create a framework for the protection of users of the system. This meant a careful separation of management functions and the establishment of an investor protection fund in December 1998. The purpose of the fund was to provide for compensation and return of customer assets in case of securities company bankruptcy.

2.6 Efforts toward Further Internationalization of the Capital Market since the Late 1990s

The process of Japan's capital liberalization spanned the 1960s to the 1990s and the Big Bang, at which point one can say that the opening up of Japan's capital markets had finally reached its completion. However, as the rest of the world's markets rapidly globalized after the 1990s, the bursting of Japan's economic bubble and the years of deflation which followed blunted the practical reality of globalization, and Japan's market (i.e. the Tokyo Stock Exchange) found that its position in the world had not risen much. The systemic changes of Japan's Big Bang had been completed by the 2000s, and since that time arguments have continued on a yearly basis regarding how more reforms might be made to reactivate the market.

As an example of this continuing process, in December 2007 the Financial Services Agency announced its plan to strengthen the competitiveness of the financial and capital markets whose purpose was to reactivate the market. This plan consisted of (1) Streamlining the market for professional investors, (2) Simultaneous participation in more than one exchange (for instance financial products and commodities), (3) Review of the firewall regulation separating banks, securities, and insurance as a means of reactivating the financial services business, and (4) Implementation of better regulations (financial administration). Of the items in this list, establishment of a market for professional investors has yet to be achieved. Nor has (2), the concept of a comprehensive exchange, quite gotten off the ground. Hence the search continues for means by which to achieve the desired effects.

An Account of the Liberalization and Opening Up of Japan's Capital Market, and a Comparison with China Acting as an Example of a Developing country Chart 1

Japan's Experience of Liberalization	The Situation in China
OECD membership, joins IMF8 (1964)	Joins IMF8 (liberalization of trade transactions, 1996)
Liberalization of inward direct investment (progresses in stages between 1967 and 1973).	Policy to introduce foreign capital (1979) Lifting of ban on renminbi-denominated inward direct investment (2011) Announcement of Catalogue for the Guidance of Foreign Investment Industries (1995) Starts up Shanghai free trade test zone using negative list method (2013)
Liberalization of inward securities investment (progresses in stages between 1967 and 1971).	Qualified Foreign Institutional Investor program (QFII) (2002) Renminbi Qualified Foreign Institutional Investor scheme (RQFII) (2011) Shanghai-Hong Kong Stock Connect (2014)
Liberalization of outward securities investment (progresses in stages between 1970 and 1972).	Qualified Domestic Institutional Investor program (QDII) (2006) Shanghai-Hong Kong Stock Connect (2014)
Issuance of yen-denominated bonds by non-residents begins (1970)	Issuance of Panda Bonds by International Finance Corporation and Asian Development Bank (2005)
Licensing of foreign securities companies (1971)	Securities Company Merger No. 1 gives birth to China International Finance Ltd. (1995)
Foreign securities section added to Tokyo Stock Exchange (1973)	
Issuance of Euroyen bonds by non-residents begins (1977)	Hong Kong Monetary Authority approves issuance of renminbi-denominated bonds by organizations from outside the region (2010)
Complete revision of Foreign Exchange and Foreign Trade Control Act (capital transactions free in principle) (1980)	
Foreign banks authorized to deal in government bonds (1984)	Overseas renminbi settlement banks and financial authorities of foreign countries allowed entry into China interbank bond market (2010)
Issuance of Euroyen bonds by residents begins (1985)	Issuance of renminbi-denominated bonds by residents outside the region begins (Dim Sum Bonds, 2007) Issuance of Dim Sum bonds by Chinese subsidiaries of foreign-owned banks (2009)
Bond futures market established (1985)	Government bond futures introduced on test basis between 1992 and 1995 then halted. Trading of government bond futures restarted (2013)
Tokyo Stock Exchange membership rights extended to foreign securities companies (1986)	Special membership in stock exchange granted to local subsidiaries of foreign securities companies (2002)
Introduction of stock index futures (1988)	Stock index futures introduced (2010)
Entry of foreign-owned companies authorized in investment trust business (1989)	Entry of foreign-owned companies into fund management business authorized (2002)
Securities and Exchange Surveillance Commission (1992)	
Financial Supervisory Agency established (1998)	Financial Supervisory Commission established (1992)
Further revision of Foreign Exchange and Foreign Trade Control Act (advance reporting abolished) (1998)	

Source: Compiled by DIR from various sources.

3. Liberalization of Capital and its Effects, Rules Remaining

3.1 Liberalization of Inward Direct Investment and its Effects

3.1.1 An Account of Liberalization of Inward Direct Investment

Liberalization of inward direct investment progressed in stages after 1967 when Japan gained membership in the OECD. During first stage liberalization of inward direct investment in 1967 automatic approval was given for foreign ownership of up to 100% in 17 industries and up to 50% foreign ownership in another 33 industries. As for the remaining industries which were not liberalized, acquisition of shares for the purpose of management participation was authorized within the limits allowable for inward direct investment (see further detail later in this section). During the 2nd phase liberalization of 1969, automatic approval was given for foreign ownership of up to 100% in 44 industries and up to 50% foreign ownership in another 160 industries. Phase 3 liberalization in 1970 gave automatic approval for a much greater range of industries (up to 100% for 77 industries and up to 50% for 447 industries). Then in 1971 on Phase 4 of liberalization, up to 100% foreign ownership was authorized automatically for 228 industries and up to 50% for all other industries with the exception of 7 industries which required case-by-case screening (in other words these industries were not liberalized).[3] In 1973 nearly 100% liberalization was implemented with the exception of 5 industries (agriculture, forestry and fisheries, mining, oil, leather and manufacture of leather products, and retailing with more than 11 outlets).[4] For all other industries, the establishment of new companies with up to 100% foreign ownership was given automatic approval. The five industries which were made exceptions remained closed to foreign ownership for reasons ranging from agricultural policy to the protection of resources and policies protecting small business. As for the retailing industry, 100% liberalization was implemented in 1975.

According to the 1980 revision of the Foreign Exchange and Foreign Trade Control Act, outward direct investment was changed from an authorization requirement to an advance reporting system, and in 1992 changed again to after-the-fact reporting with certain items requiring advance reporting. Items requiring advance reporting were those falling under the OECD capital movements liberalization code identifying industries in which major capital movements or foreign ownership "may compromise national security and the maintenance of public order, or may interfere with the protection of public safety." Industries included under this definition are aircraft, weapons, nuclear power, and space development.

The following conditions must be met for authorization: (1) Contributes to improving the international balance of payments, (2) Contributes to the development of public works, and (3) Necessary for maintenance and renewal or change in technical support contract associated with important industries or public utilities and other public works. These are the positive criteria. Meanwhile, the negative criteria, in other words situations for which authorization must not be given, are (1) If articles are present in contracts which deemed lacking in fairness or in violation of the law, (2) If the signing or renewal of a contract is recognized as being fraudulent or performed under duress or undue pressure, (3) If a situation is recognized as having negative influence on the reconstruction of Japan's economy, and (4) With the exception of particular cases as established by law, if the counter-value of stocks, equity interest, beneficiary certificates, corporate bonds, or claimable assets arising from loans

[3] In response to US demands, up to 50% foreign ownership was automatically authorized for 6 automobile related industries during Phase 3 and Phase 4 liberalization. Authorization of up to 100% foreign ownership was authorized on Phase 5 capital liberalization.

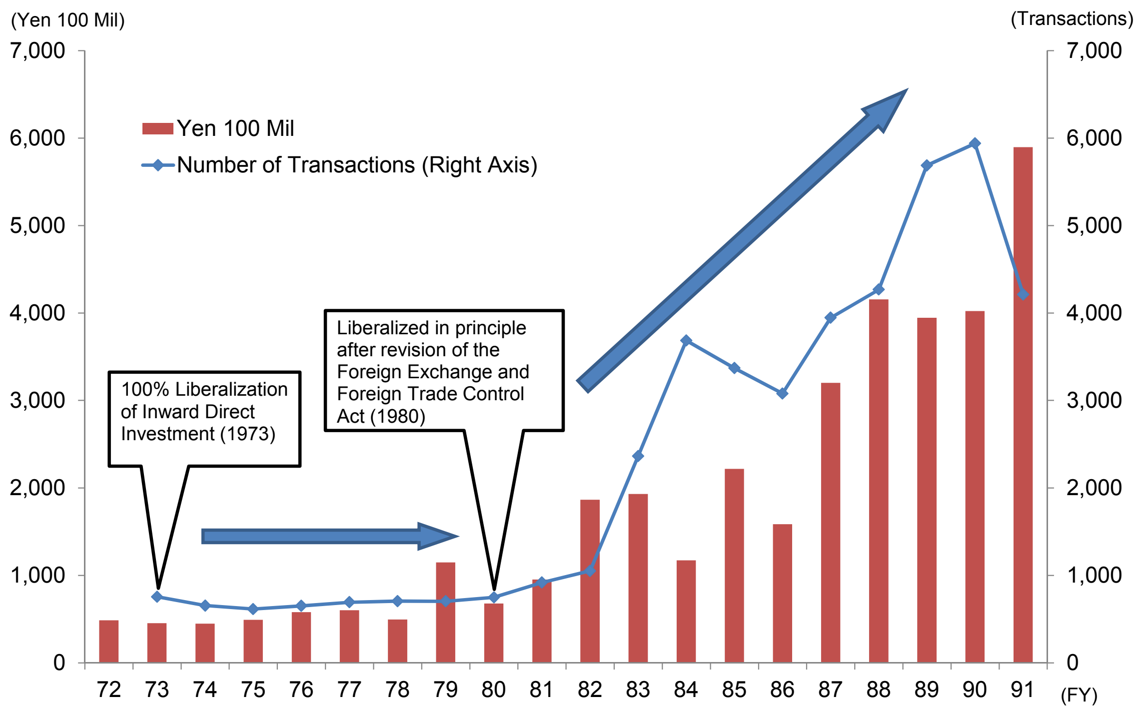
[4] A grace period of 2-3 years is applied in the case of 17 industries, including electronic calculators and other instruments.

acquired is not yen converted from foreign currency.[5] In the course of working toward liberalization, the extent to which emphasis was placed on positive criteria began to decline, while negative criteria gradually took on more weight. This was due to the policy of authorizing applications in a liberalized environment. Situations not liberalized were now limited to foreign capital deemed in some way harmful.

3.1.2 Performance of Inward Direct Investment

The extent of growth in inward direct investment during the years just after its liberalization in the 1970s was unremarkable. The amount in inward direct investment authorized or reported annually stayed at around 50 bil yen. However, this amount grew considerably after the revision of the Foreign Exchange and Foreign Trade Control Act in the 1980s. By 1990 inward direct investment had reached 400 bil yen annually.

Performance of Inward Direct Investment (Authorization or Reporting) **Chart 2**



Source: Ministry of Finance (International Finance Bureau Annual Report); compiled by DIR.

Though Japan's inward direct investment definitely grew along with the opening up of Japan's market, looked at in a global context it is actually at a low level. Inward direct investment as a percentage of Japan's GDP was only 3.4% as of the year 2012 as compared to the OECD average of 30%, revealing an especially low level as compared to overall OECD membership. According to the American Chamber of Commerce in Japan's 1991 Report on Trade and Investment in Japan, there were various disincentives to investing in Japan, including the high cost of real estate, the difficulty of acquiring human resources, exclusive trade and business practices, cross-shareholding, the high cost of distribution, plus a distribution system which is uniquely complex. These conclusions are echoed in a 2014 report issued by the Ministry of Economy, Trade and Industry entitled "Expert Advisory Panel Report on Direct Investment in Japan." The reasons stated for the failure of investment in Japan to grow include the following: the difficulty of obtaining human resources due to the low level of mobility in Japan's labor market, high energy costs, a complex distribution system which leads to high costs for distribution, and a high corporate tax rate. A concrete example of the problem is that when

[5] Only foreign capital introduced in the form of foreign currency or its equivalent may be authorized, therefore if it cannot be confirmed that said amount is the amount of foreign currency lawfully converted into yen, negative criteria are used in making the decision.

selling a product in Japan a label unique to Japan is required. Then, even if additives in a food product are deemed safe in accordance with WHO and FAO standards, sale in Japan may still not be recognized according to Japan's own unique standards. These regulations are put into place for the convenience and protection of the consumer, but despite the liberalization of capital in Japan, its unique regulations and business customs still end up creating barriers to inward direct investment.

3.2 Liberalization of Inward and Outward Securities Investment and its Effects

3.2.1 An Account of Liberalization of Inward Securities Investment

Inward securities investment in Japan became possible in 1949 according to the Foreign Exchange and Foreign Trade Control Act, with additional liberalization measures provided by the implementation of the 1950 Law on Foreign Capital. However, only dividends associated with stocks and beneficiary certificates could be sent overseas in the form of foreign currency, whereas payment of principal was limited by restrictions. Though it became possible to send payment of principal overseas as of 1952, a 7-year period was required (2-year grace period plus 5-year installment period).[6] Limitations on sending payments of principal overseas were lowered in stages, and as of 1963 were abolished.[7]

Inward securities investment originally required government approval, but in 1952, the Foreign Exchange and Foreign Trade Control Act introduced a new automatic approval system, according to which a certain range of transactions were automatically approved by the Bank of Japan. If the transaction fell within the established frame for automatic approval, the Minister of Finance would give automatic approval with the consent of the issuing company. If there was no consent, the Minister of Finance would perform case-by-case screening. At first, the range covered by automatic approval was 8% or less of foreign ownership for non-restricted industries and 5% for restricted industries, but in 1960 this was changed to 15% for non-restricted industries and 10% for restricted industries. The upper limit for individual shareholders was also raised at this time to 5%. After this point the range covered by automatic approval broadened more and more until it reached 100% in 1973 as long as interested parties consented, though there were still some exceptions to the general rule. Approval then became unnecessary after the revision of the Foreign Exchange and Foreign Trade Control Act in 1980. After this point only advance notification was required, and reporting was unnecessary for designated securities companies.

At one point in the process of liberalizing inward securities investment, there came a point when inflow of investment capital thought to be from short-term speculators grew rapidly. The response was to place restrictions on capital inflow by implementing regulatory measures limiting net inflow of capital from non-residents. The restrictions began in October of 1972 and lasted one year (till November 1973 for stocks and December 1973 for bonds). Concretely speaking, the measure was enforced by virtue of requiring that applications for inward securities investment be made only through an authorized foreign exchange bank[8] or securities company. The amount of acquisition was also restricted to remaining within the range of the amount of disposal.

[6] "Sengo Kawase Kanri no Seiritsu" (Postwar Foreign Exchange Control), by Yoshio Asai (January 2012), Seijo University, Keizai Kenkyu Dai 195 (Economic Research, No. 195)

[7] If terms stated that the principal would not be sent overseas, then investment in industries other than those with restrictions could be carried out freely between 1956 and 1964 in accordance with the program for free acquisition of yen-based stocks. The investment track record under this program was 283 corporate mergers, with book value of foreign capital invested totaling 140 mil dlrs.

[8] Banks with authorization from the Minister of Finance to carry out foreign exchange transactions. In the past, Japan required all foreign exchange transactions to be carried out through a bank. This system was eliminated in 1998.

Change in Automatic Approval System and Restrictions on Remittance of Principal **Chart 3**

Year	Restricted Industries	Non-Restricted Industries	Upper Limit of Individual Shareholdings	Restricted Period for Remittance of Principal	Comments
1952	5% or less	8% or less	---	(2-year grace period plus 5-year installment period)	BOJ automatic approval system introduced
1960	10% or less	15% or less	5% or less	Remittance period shortened (2-year grace period plus 3-year installment period)	
1961	Same as above	Same as above	Same as above	Remittance period shortened (2-year grace period)	
1962	Same as above	Same as above	Same as above	Remittance period shortened (6-months grace period)	
1963	Same as above	Same as above	Same as above	Remittance period limitation abolished	
1967	15% or less	20% or less	7% or less	---	1st phase capital liberalization
1970	Same as above	25% or less	Same as above	---	3rd phase capital liberalization
1971	Same as above	Same as above	10% or less	---	4th phase capital liberalization
1973	100% liberalization with consent of interested parties (some exceptions remain)				5th phase capital liberalization

Source: Okabe (1989); compiled by DIR.

3.2.2 Performance of Inward Securities Investment

Inward securities investment maintained a fairly low level between 1950 and 1960 at 2 mil dlrs annually (720 mil yen at 360 yen to the dollar). Then between 1960 and 1963 it grew to 100 mil dlrs annually (36 bil yen at 360 yen to the dollar).[9] This is most likely due to the fact that regulations regarding remittance of principal were eased, as well as the revival of Japan's economy.

Inward securities investment differs fundamentally from Inward direct investment in that its main purpose is asset management, and the inflow and outflow of funds is easily influenced by the condition of overseas economies. In 1964, a dollar outflow deterrence policy was adopted in response to the US interest equalization tax implemented that year, and Japan's economy fell into recession, leading to a decline in inward securities investment. Meanwhile, in 1973 the first oil crisis hit, followed by a second oil crisis in 1978, causing a major outflow of investment capital, taking an additional bite out of inward securities investment. Both inflow and outflow of capital continued to expand, reaching an annual net of 500 bil yen before 1980. After 1980 there were some years in which it exceeded 1 tril yen, with capital inflow exceeding 20 tril yen annually during the 2000s.

The American Chamber of Commerce in Japan mentions cross-shareholding as one of the barriers to investment in Japan in its report mentioned earlier in the previous chapter. This practice was common in Japan until the mid-1990s as many corporations sought stable shareholders. Hence it was only later in the 1990s that inward securities investment on the part of overseas investors began to grow.

During the early postwar period in Japan attempts were made to break up the old Zaibatsu oligarchy. Between 1946 and 1947, stock shares held by conglomerates (holding companies) such as Mitsui, Mitsubishi, Sumitomo, Yasuda, and Fuji Industrial (Nakajima Aircraft), as well as shares held by Zaibatsu families, were released to individual shareholders.[10] But then the US occupation policy took a

[9] Ministry of Finance International Finance Bureau Annual Report (1977).
[10] "Stockholding in Japan (1)" by Tadao Kitajima (Feb. 1984) Meiji University Institute of Research on Commerce, Meiji University Collected Essays on Commerce, "The problem of Corporate Groups During the Postwar Period" by Hiroji Uno (March 1972) Gakushuin University Economic Journal Vol. 8 No. 3 Pgs. 3-30

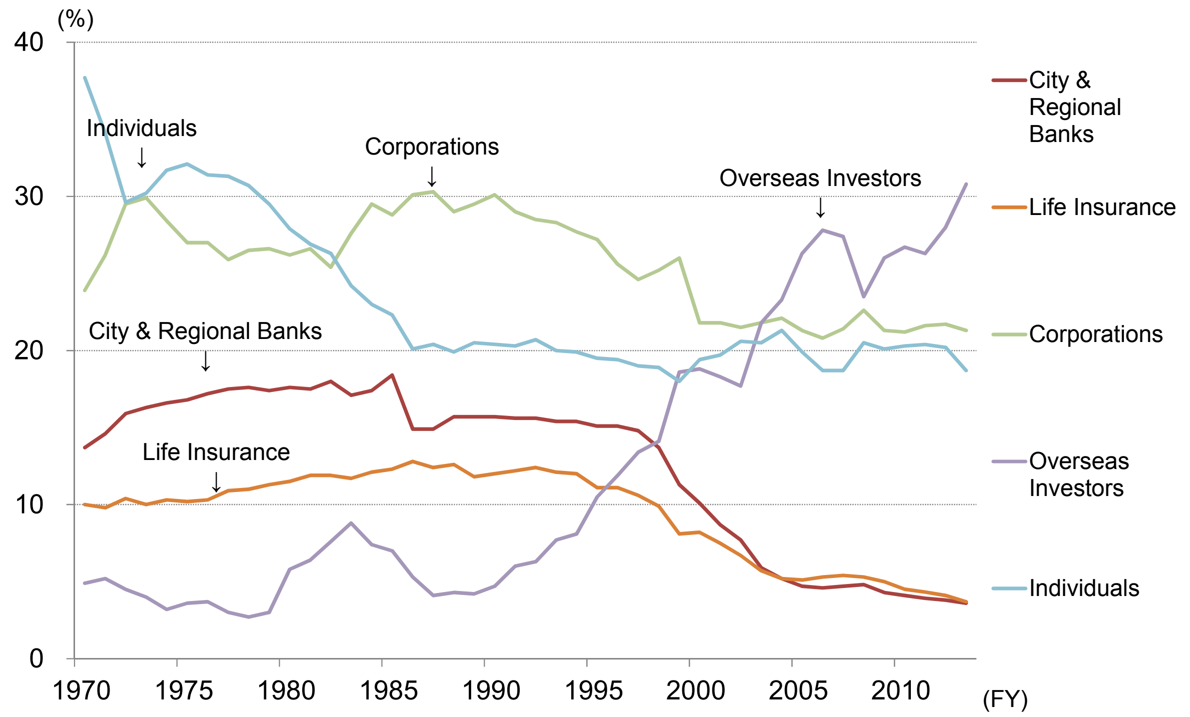
new turn, and in 1952, the prohibition on the use of Zaibatsu trade names and trademarks (Official Notice of the Holding Company Liquidation Commission, Sept. 1949) was removed. Meanwhile, the Antitrust Act was eased in 1949 and 1953, leading to a resurgence of Zaibatsu group companies, and cross-shareholdings again took place in order to strengthen internal unity. The prewar Zaibatsu were centralized organizations in which the holding company held the majority of shares in its affiliates, thereby exercising enormous power and authority over how those companies were managed, including human resources and other aspects of business. The postwar Zaibatsu corporate groups differed in that they were not run by a centralized authority. Instead, groups were organized by banks which provided financing, while cross-shareholding occurred amongst members. Company officers would be dispatched to group members and meetings of presidents of the group companies were regularly held. But group companies were essentially independent organizations working in parallel with each other, while at the same time developing close relationships.

After the 1970s, the liberalization of capital triggered fears that hostile takeovers by foreign-owned companies might increase. This became a factor leading to a strengthening of cross-shareholding for the purpose of maintaining a stable group of shareholders. Cross-shareholding meant that shareholder behavior did not change even when stock prices soared (shares would not be sold off for profit-taking), and the main bank system was at one time evaluated highly as an important support system which moved Japan into its high growth period. When business performance was bad, a group company could sell shares with unrealized gains and record that as earnings. Since 1988, a capital adequacy requirement was imposed on banks, and inclusion of unrealized gains from stocks in owned capital (or net worth) was recognized. Hence unrealized gains from stocks held by banks could be used to raise the level of net worth. However, once Japan's economic bubble burst and economic conditions worsened, the cross-shareholding scheme no longer functioned as it used to as stock prices continued to decline. Corporations whose earnings had fallen considerably had to sell off stocks in which they still held unrealized gains since their core business was suffering losses. This meant a reduction in shares held in other group companies. Then in the year 2000 cross trading was banned,[11] while the introduction of market-to-market accounting in 2001 caused a further decline in cross-shareholdings. In 2002 the "Act on Limitation on Shareholding by Banks and Other Financial Institutions" was imposed on banks, prohibiting the holding of shares exceeding an amount equivalent to net worth.

This series of developments led to the dissolution of cross-shareholding, and it was overseas investors who reaped the benefits. As of 1995 the ratio of stocks owned by overseas investors did not even reach 10%, but the ratio grew rapidly until it exceeded 30% by FY2013.

[11] Cross trading is where stocks with unrealized gains are sold but then bought back at the same time. Profits on the sale are recorded as corporate earnings, while the company actually continues to hold those same shares.

Ratio of Shareholdings by Type of Investor **Chart 4**



Source: Tokyo Stock Exchange; compiled by DIR.
Note: Until 1985 the category of commercial banks and regional banks included trust banks.

3.2.3 An Account of Liberalization of Outward Securities Investment

The OECD requested that Japan liberalize outward securities investment in 1964, but the government delayed taking action due to a shortage of foreign currency reserves and worries that the balance of international payments might worsen. For this reason liberalization of outward securities investment came later than it did for inward securities investment. However, liberalization progressed rapidly in the early 1970s and onward.

The balance of foreign currency reserves began to grow in the late 1960s, and in 1970 the government recognized the purchase of stocks and bonds listed on overseas markets for the first time. Permission to acquire foreign securities was granted to Japan's four major investment trust management companies (Daiwa, Nomura, Nikko, and Yamaichi) with an upper limit of 100 mil dlrs. Purchase would take place on any of eight different overseas stock markets, including New York, London, Paris, Frankfurt, Amsterdam, Sidney, Zurich, and Toronto. The upper limit of 100 mil dlrs was thrown out in 1971, and within the same year, outward securities investment was recognized on the part of other investment trust management companies, as well as life and non-life insurance companies, and general investors. In February of 1972, investment trusts were also allowed to engage in outward securities investment, and in March of the same year, certain institutional investors were allowed to purchase any kind of foreign securities issued, regardless of whether they were listed on foreign stock exchanges or non-listed. Liberalization of sales by foreign investment trusts was implemented in the same year, and the means of engaging in outward securities investment spread even more. Purchase of stocks and bonds listed on foreign stock exchanges by securities companies on the securities company's own account was liberalized in 1971.

As for the regular investor (i.e. the general public) trade was still limited to certain stocks for the purpose of investor protection, but this restriction was lifted gradually. Other stock exchanges where trade could be carried out were added to the original list of eight foreign stock exchanges, with the American Stock Exchange and Luxemburg added in 1971, followed by Milano and Brussels in 1972. In 1973, Wellington, Madrid, and Montreal were added to the list. After 1973, the Japan Securities

Dealers Association, a self-regulatory organization, produced its own set of regulations under the title "Rules for trading of foreign securities." The Dealers Association placed a limit on the range of foreign stocks and bonds which could be purchased to those listed on designated foreign stock exchanges or designated foreign over-the-counter markets and which publish stock quotations.[12] The purchase of unlisted securities was recognized in 1977.

As was the case with inward securities investment, the revised version of the Foreign Exchange and Foreign Trade Control Law implemented in 1980 made authorization to purchase securities on overseas stock exchanges unnecessary. As of this point outward securities investment had become "free in principle."[13]

3.2.4 Performance of Outward Securities Investment

Despite the advances in liberalization, Japan's outward securities investment did not become truly active until the late 1980s. The originally established upper limit of 100 mil dlrs on balances was abolished in 1971. This was because institutional investors had restrictions placed on them both in the areas of stock (the ratio of foreign assets held to gross assets) and flow (limitation on monthly investment amount). These restrictions were finally eased in 1986 in response to the Plaza Accord of 1985, after which the surplus in current account balance swelled all at once, while the yen grew rapidly stronger at the same time. Concretely speaking, in terms of stock, as of 1971 holdings were restricted to 10% of gross assets. This restriction was eased twice in 1986, first from 10% to 25%, then from 25% to 30%.[14] As for flow, a restriction was imposed in 1982 on insurance companies whereby the percentage of increase in assets which could go toward investment in overseas bonds was limited to 5% or less. This was raised to 10% during the same year and to 20% in 1983. The restriction was eliminated in 1986.[15]

For a period of five years starting in 1985, outward securities investment on an annual basis exceeded 10 tril yen net, but once Japan's economic bubble burst in the 1990s performance became stagnant. Outward securities investment entered a new growth phase after the year 2000 as investors increasingly diversified their portfolios in response to the limited opportunity for profit taking on domestic investments due to low interest rates which persisted over the long-term.

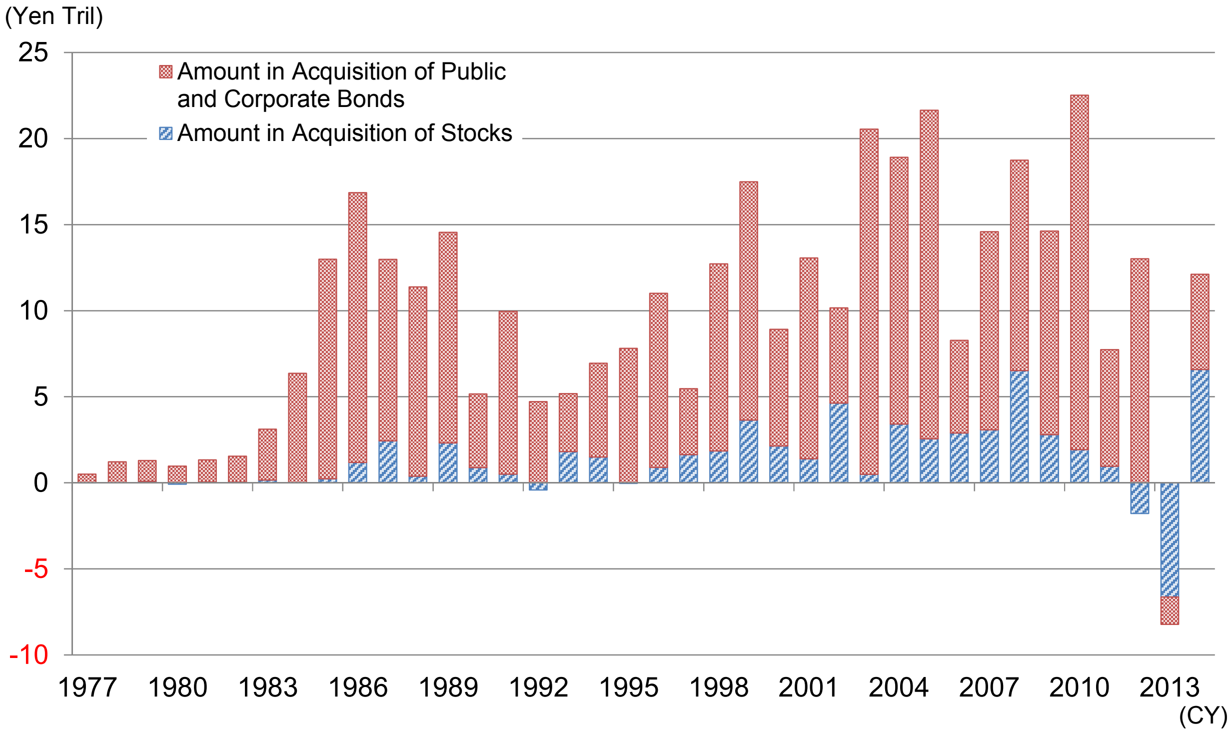
[12] More exchanges were added to the list of exchanges where purchase of foreign securities could take place in 1977, including Hong Kong, the gold and silver exchange, the Far East Exchange, Kuala Lumpur, Singapore, Manila, Makati and Pacific, as well as NASDAQ. In 1983 Vienna was added. Currently there are no restrictions in place regarding any stock exchanges or over-the-counter markets.

[13] Before the revision of the Foreign Exchange and Foreign Trade Control Law, authorization of the Minister of Finance was required. However, in actual practice, umbrella authorization was given to certain institutional investors, including insurance companies, authorized foreign exchange banks, and securities investment trust management companies. As for general investors, umbrella authorization was also given to purchases made through a securities company. Hence in actual practice, liberalization had already taken place.

[14] "From Financing of Foreign Trade to Foreign Investment in the 1970s, and Japan's Foreign Financing in the 1980s," by Hiroshi Okuda, Ritsumeikan Annual Review of International Studies Vol. 19 No. 2 (Oct. 2006) Pg. 51-69

[15] A restriction of less than 40% of asset increase was imposed on trust banks between April and August 1986.

Changes in Outward Securities Investment **Chart 5**



Source: Ministry of Finance (International Finance Bureau Annual Report), FRB; compiled by DIR.
Note: There is a lack of continuity between data recorded after 1996 and earlier data due to a change in method of calculation.

3.3 The Effects of Capital Liberalization

There are those who evaluate Japan's having gone ahead with capital liberalization and the entry of foreign-owned corporations into the domestic market in a positive light, and there are those who are more skeptical, expressing worries in regard to possible adverse effects.

The positive evaluation focuses for the most part on growth in GDP due to increased capital expenditure and employment, as well as improvement in productivity and competitiveness, and innovations in management and sales. Assuming that the entry of foreign-owned corporations into the domestic market leads to net economic growth, then capital expenditure and employment, not to mention the economy overall should naturally expand. However, if domestic corporations were simply weeded out in a process of economic natural selection, it would not necessarily lead to an overall expansion of the domestic economy. On the other hand, if the presence of more efficient foreign-owned corporations were to lead to the loss of inefficient corporations in a shakeout, the domestic economy and the particular industry in which the shakeout took place would then experience an improvement in productivity and competitiveness. It is also conceivable that domestic corporations would improve their productivity and competitiveness as a result of the competition brought by foreign-owned corporations. In addition, the influence of management and sales methods introduced by foreign-owned corporations having different customs and business practices than Japanese corporations would very likely lead to the vitalization of industry. Depending on the particular methods, some might lead to further reforms in existing regulations. And there is a high probability that those Japanese corporations which survive the increased competition would then enter overseas markets. Hence the possibility that foreign-owned corporations entering the domestic market have higher productivity than Japanese corporations is actually a positive factor.

Once the effects of foreign-owned corporations having entered the Japanese market become all-pervasive, they will simply become a part of everyday life. Meanwhile, considering the development of Japan's economic bubble and its ultimate collapse, and then the effects of innovative change and later stagnation on other industries, it is difficult to make quantitative observations on said effects over a long period of time. To a certain extent, however, we can find a positive correlation between the average value of year-to-year change in inward direct investment and the growth rate in total-factor productivity (TFP). The TFP figure provides a measurement of the rate of change in a country's overall production amount minus labor input and capital input, and is thought to also express progress in technology and innovative change in methods of management and sales. During periods in which Japan's TFP showed a high growth rate, such as the late 1970s when it was at 1.6% and the late 1980s when it was again 1.6%, the average value of year-to-year change in inward direct investment was at 30% or higher.[16] In contrast, during periods in which the TFP growth rate was negative, such as the early 1990s when it was at -0.1% and the late 2000s when it was -0.6%, the average value of year-to-year change in inward direct investment was in single digits. During the late 1990s the average value of year-to-year change in inward direct investment was at 50% or more despite the fact that the TFP growth rate was -0.2%. This discrepancy is thought to be due to the fact that during this period, there was a series of bankruptcies amongst major financial institutions, plus the Asian currency crisis was strongly felt in Japan.

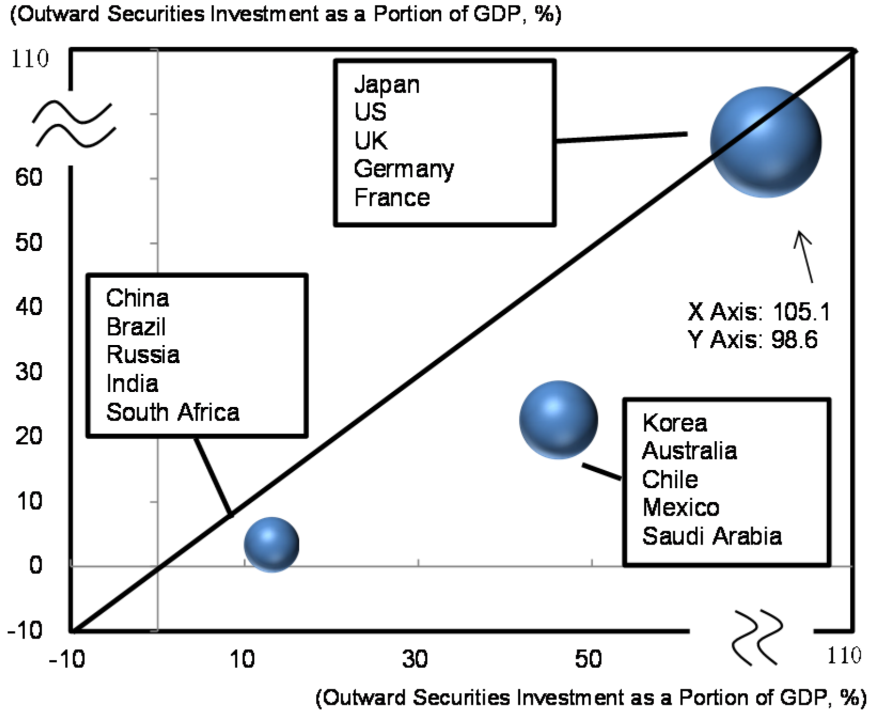
As for the skeptics and their positing of possible adverse effects, the following issues are cited. The income of foreign-owned companies will flow out of the country and back to the home country of said business, hence contributing little to Japan's GDP. Foreign corporations have a relatively shorter cycle than do domestic corporations, meaning the possibility of restructuring or even pulling out of the market fairly quickly, creating instability for employment. Meanwhile, Japanese technology could leak out of the country through M&A, while technical experts could be enticed to leave by competitors. And security could be threatened by leakage of security related technology, infrastructure, or acquisition of land by foreign-owned corporations. Finally, damage could occur to the public interest by the drive for excessive efficiency, including the demise of businesses run for the public good due to competition from companies placing profit above all else. As for the concern that business income will flow out of the country, this depends on the amount of backflow to the domestic economy. It is difficult to say which has the greatest effect. Meanwhile, the issue of income stability can be handled by providing a sufficient safety net and a labor market in which it is easy to find reemployment. As for the outflow or leakage of technology, security concerns, and possible damage to the public interest, these can be handled by regulations regarding foreign-owned corporations as explained further below.

Aside from the direct effect on the domestic Japanese economy, one has to keep in mind when placing restrictions on foreign-owned corporations entering the domestic market, that when Japanese companies begin to aggressively enter overseas markets the same kind of restrictions may be applied to them. If one is working on the assumption that an international economy based on free trade is the way to achieve wealth for all countries involved, then you also must assume that seeking the maximum amount of freedom for corporations to do business equally in all countries is the way to achieve mutual benefits.

When a country's economy is still developing and its share of the entire world economy is still fairly small, it is practical to a certain extent to place restrictions on capital and to implement protective policies while still growing and cultivating one's own domestic companies. However, once the domestic economy matures and globalization has progressed to a certain stage, it makes sense to promote the liberalization of capital, as this becomes the foundation of further growth for the domestic economy and domestic corporations.

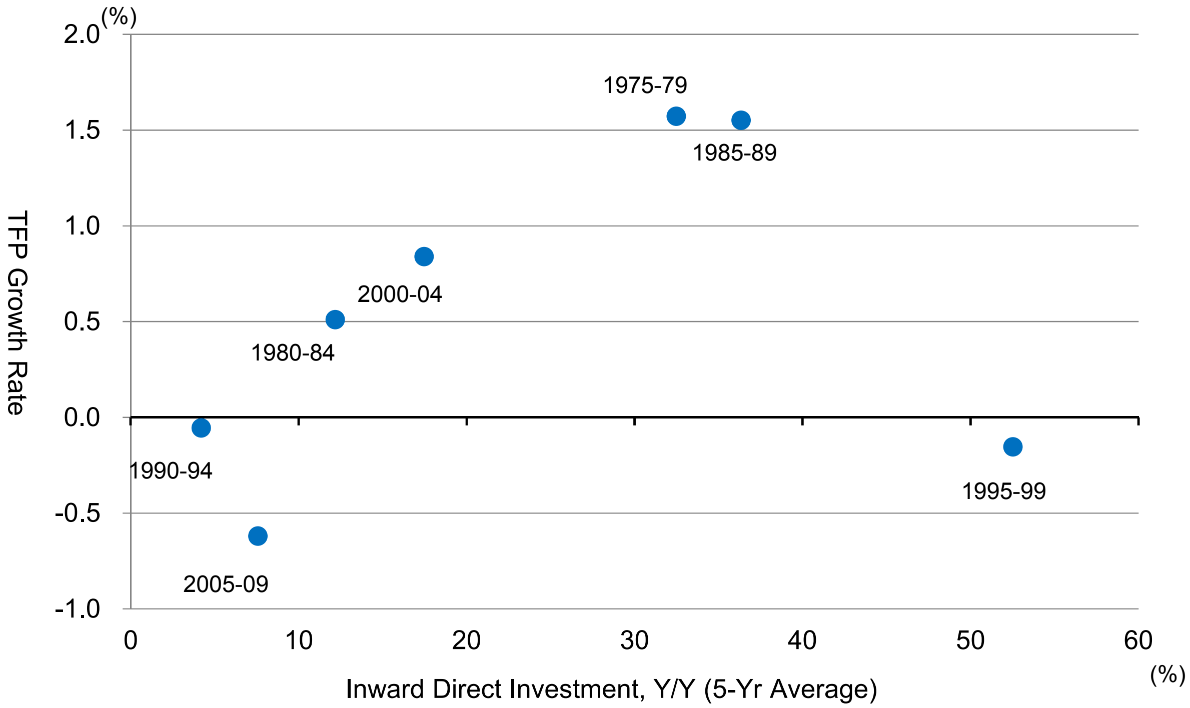
[16] The TFP growth rate is an all-industry measurement. Here we use the TFP figure as it appears in the METI publication "White Paper on International Economy and Trade 2013, Part I Chart 1-3-1 All-Industry Labor Productivity and TFP," (Pg. 11).

The Relationship Between the Extent to Which the Capital Market is Liberalized and Inward & Outward Securities Investment — Chart 6



Source: IMF, Chinn-Ito Index; compiled by DIR.
Notes: 1) The size of the circles indicates the extent to which the capital market is open. Based on this index, samples (a total of 97 countries) are divided into three groups based on the extent to which their capital markets are open, and each group's total value in dollars calculated.
2) We use the Chinn-Ito Index, which measures financial openness by applying numeric values to restrictions on cross-border transactions, including current and capital transactions.

Inward Direct Investment in Japan and Total-Factor Productivity (TFP) — Chart 7



Source: Ministry of Economy, Trade and Industry "White Paper on International Economy and Trade 2013", Ministry of Finance "Government Finance Statistics Monthly", "Status of International Balance of Payments", Bank of Japan; compiled by DIR.
Note: Inward direct investment is expressed as a total amount up to FY2004. As of FY2005 the definition changes to "Inward direct investment inflow – Return on reinvestment". Before FY1994 dollar indications were converted to yen.

3.4 Restrictions on Foreign Investment under Capital Liberalization and Maintenance of Public Interest

Bringing in overseas investors and corporations promises to vitalize the domestic economy by expanding the options for capital procurement, improving productivity, and creating more employment opportunities.

However, even as liberalization progresses, it becomes evident that certain industries require public involvement, especially areas such as guarantee of security, public infrastructure management, universal service, and producer protection. These areas are in need of provisions such that foreign investment will not interfere with policy objectives. The most direct method is to make these areas publicly-owned companies, but even companies listed on the stock market can be required to have shares held by the government. Individual business laws can also be established to regulate particular industries, or golden shares[17] can be introduced.

3.4.1 Restrictions on Foreign Investment through Individual Business Laws

Restrictions on foreign investment through individual business include the following: The Mining Act, the Nippon Telegraph and Telephone Corporation law, the Radio Act, the Broadcast Act, the Marine Act, the Civil Aeronautics Law, and the Consigned Freight Forwarding Business Act. The Nippon Telegraph and Telephone law forbids transfer of shares if foreign voting rights exceed a particular amount, while licenses can be disqualified in radio and other broadcasting (the Radio Act and the Broadcast Act). Furthermore, the OECD capital movements liberalization code identifies industries in which major capital movements or foreign ownership "may compromise national security and the maintenance of public order, or may interfere with the protection of public safety."[18] Industries included under this definition are aircraft, weapons, nuclear power, and space development, as well as electricity and gas, heat supply, communications, broadcasting, and railways. Restrictions on foreign investment in these areas is recognized by the OECD. As for industries other than these, restrictions may be found necessary for certain industries based on unique factors in a particular country. In this case, a report must be submitted to the OECD for reserved industry status.[19]

Restrictions placed on foreign investment by each of the business laws previously mentioned are listed below. The Nippon Telegraph and Telephone Corporation law is discussed in section b) Government Ownership.

The mining act does not recognize the acquisition of mining rights by foreigners.

The Radio Act and the Broadcast Act stipulate that foreigners are disqualified from obtaining a license if their voting rights are 1/5 or more. Licenses for radio stations and key broadcasters shall not be given to any persons who do not hold Japanese citizenship, including foreign governments and their representatives, subsidiaries of foreign corporations and organizations. Furthermore, licenses will not

[17] A golden share holds special voting rights, giving its holder the ability to block another shareholder from taking more than a ratio of ordinary shares.
[18] "Attracting Foreign Investment and Restrictions on Foreign Investment" by Nobuki Hirose, National Diet Library, Research and Information – Issue Brief, No. 600 (11/8/2007), pg. 5
[19] Information obtained from the following publications. However, portions of content on the Internet were deleted. Hence detail on which industries are involved could not be found: "OECD Code of Liberalisation of Capital Movements 2007," OECD, and Ministry of Economy, Trade and Industry "Research Committee on the International Investment Environment in a Global Economy – Midterm Summary" (4/26/2007). What appears to be the most recent issue of the above mentioned OECD publication in 2013 contains a section entitled "Public Order and Safety," which lists the following areas as exceptions: a) Maintenance of public order and public health, morals, and safety, b) Ensuring national security interests, c) Realization of obligations regarding international peace and safety.

be given to corporations or organizations which represent foreign entities or which have 1/3 or more foreign directors, or where foreigners hold 1/3 or more of voting rights.[20]

According to the Marine Act, it is a requirement of Japan shipping that 2/3 or more directors seated on the board of a shipping company hold Japanese citizenship. Furthermore, non-Japanese ships, with the exception of those stipulated according to law or established in their articles of incorporation or in case of emergency, may not make port calls in closed ports or handle goods or passengers in Japanese ports.

According to the Civil Aeronautics Law, and the Consigned Freight Forwarding Business Act, air carriers and their subsidiaries have as a requirement to retain their business license that foreigners shall not hold more than 1/3 of the company's directorships or voting rights.

3.4.2 Government Ownership Requirement

Companies listed on the Tokyo Stock Exchange requiring government ownership as of March 2015 include NTT at more than 1/3 government ownership and Japan Tobacco also with over 1/3 government ownership. Companies scheduled to be listed include Japan Post Holdings with more than 1/3 government ownership. Meanwhile, corporations with plans for listing and which are also slated for privatization (all government held shares will be sold) include the Development Bank of Japan and the Shoko Chukin Bank. As for these last two organizations, the law related to government ownership of these companies was partially revised during the 189th ordinary session of the Diet convened on January 26, 2015. According to the revised law, government ownership will be required during periods requiring crisis response operations and designated investment operations. During the current period of designated investment operations (until end of FY2025), government ownership of the Development Bank of Japan will remain at more than 1/2. During crisis response government ownership will be over 1/3. As for the Shoko Chukin Bank, the government "will hold whatever stocks are required." (The government already holds over one half of Shoko Chukin Bank shares, about 46%.)

According to Japan's corporate law, questions of fundamental importance to the business, including any change in the company's articles of incorporation, dissolution, merger, company split and liquidation, or the transference of the entire business or important portion of the business to another party, must be resolved by a special resolution of the shareholders' meeting. Over two thirds of the shareholders must vote in favor of the special resolution in order for it to pass, so if the government holds over one third of shares, they can prevent anything which they believe interferes with policy objectives from passing.

The Nippon Telegraph and Telephone Corporation law was passed in December 1984, then a revised version was passed in June 1997. The NTT Law stipulates that government ownership shall be 1/3 or more, and in addition, ownership by foreigners and corporations with a majority of shares held by foreign-owned entities shall not be recognized. The obligation of government ownership has not changed since that time, however the restriction on foreign ownership was revised in May 1992 such that up to 1/5 foreign ownership is recognized. According to the law in its current form, up to 1/3 or less of foreign ownership is recognized.

In August 1984, the Japan Tobacco Law was passed, which stipulates that Japan Tobacco Inc. is required to have over 1/2 government ownership. This was later raised to over 2/3 by an interim measure. In April 2002 the law was revised making government ownership requirement over 1/2 of the

[20] The Radio Act stipulates the following: "Article 5 (1) No radio station license shall be granted to: i) A person not holding Japanese nationality ii) A foreign government or its representative iii) A foreign juridical person or organization iv) A juridical person or organization which is represented by any person referred to in the preceding three items, or one third or more officers of which are such persons, or one third or more voting rights of which are made up of the aggregate of voting rights held by such persons." However, amateur radio station, marine vessels, and aircraft radio stations are exempt from this ruling.

number of shares outstanding as of the date Japan Tobacco Inc. was established, and 1/3 of the current total number of shares outstanding. Meanwhile, the interim measure was repealed. In December 2011 the Japan Tobacco Law was partially revised as a result of The Great East Japan Earthquake Reconstruction Funding Law, which stipulates that required government shareholdings shall be over 1/3 of total shares outstanding and that profit on sales shall go toward the redemption of reconstruction bonds.

3.4.3 Maintaining the Public Interest through Individual Business Laws

There are many examples of restrictions according to individual business laws which have been used to protect the public interest. In this section we consider the Railway Business Law. Looking at railway operation from the viewpoint of maintaining the public interest, the following situations could become a concern. For instance controlling interest being held by a person or entity which is interested only in seeking short-term profit to the extent that the survival of the business is put at risk (including breakup or liquidation of corporate assets, or deterioration of safety due to the excessive seeking after short-term profit), or controlling interest being held by a company in the same business whose actions are such as to damage the interests of other companies in the same business or their customers (for instance the handling of trackage rights in interconnecting service in a way which is disadvantageous or damaging). The Railway Business Law stipulates that questions of continuity or improvement of railway business operations shall be subject to the approval and dictates of the Minister of Land, Infrastructure, Transport and Tourism,[21] and acts as a check against actions or decisions by business management which could harm the general public interest.

The largest shareholder of Seibu Holdings, US investment firm Cerberus Capital Management, proposed that some of Seibu Railway's lines be discontinued (the issue surfaced in 2013). The question of whether measures ensuring public interest in accordance with the Railway Business Law would take effect in this instance then became an issue. In the end, Cerberus withdrew its proposal when the stock market recovered and so provisions in accordance with the Railway Business Law did not come into play. (See Note 21.)

[21] Articles of the Railway Business Law associated with maintaining and protecting the public interest are as follows. Article 26 (Assignment and Receiving Assignment of Business) (1) The assignment and receiving assignment of Railway Business shall not be effective unless approved by the Minister of Land, Infrastructure, Transport and Tourism. (Remainder omitted.) Article 28 (Suspension of Business) (2) The period of the suspension of the preceding paragraph shall not exceed one (1) year. (Abolition of Business) Article 28-2 (1) When the Railway Business Operator intends to terminate the whole or part of the Railway Business (except the case where the said termination is pertaining to the freight transportation), he/she shall notify the Minister of Land, Infrastructure, Transport and Tourism to that effect one (1) year prior to the date of the termination. (2) The Minister of Land, Infrastructure, Transport and Tourism shall hear the opinions of the local governments concerned and the interested persons with respect to securing the convenience of the public pursuant to the provision of an ordinance of the Ministry of Land, Infrastructure, Transport and Tourism in the situation where the Railway Business Operator terminates pertaining to the notification of the preceding paragraph. (Remainder omitted.) Article 29 (Dissolution of Juridical Person) (1) A resolution for dissolution of a juridical person as a Railway Business Operator or consent thereto by all its members shall not be effective unless approved by the Minister of Land, Infrastructure, Transport and Tourism. (2) The Minister of Land, Infrastructure, Transport and Tourism shall give approval of the preceding paragraph except the case where it decides that the resolution for dissolution of the said juridical person or consent thereto by all its members is likely to extremely impair the convenience of the public. (Remainder omitted.) Article 22-2 (Measures for Smooth Transit, etc.) (1) The Railway Business Operator shall make efforts to take measures prescribed in the provision of an ordinance of the Ministry of Land, Infrastructure, Transport and Tourism such as mutually connecting transportation, through transportation and other measures of transit of passengers or transshipment of freight with other transportation business operators, in cooperation with such other transportation business operators and other parties concerned, for the purpose of improving the convenience of users. (Remainder omitted.) Article 23 (Order to Improve Business Activities) (1) The Minister of Land, Infrastructure, Transport and Tourism may order the following matters to the Railway Business Operator, if he/she finds that there is a fact concerning the business activities of the Railway Business that is impairing the convenience of users or other public interests. (i) Change of the upper limits of Passenger Fares, etc. or the charges for passengers (except those prescribed in paragraph 1 and paragraph 4 of Article 16), or change of the fares or the charges of freight. (Remainder omitted.)

Foreign-owned firms are not the only shareholders prone to take actions which could harm the public interest. Regulations have also been established involving individual business laws concerning the operation of businesses handling public infrastructure as a means of maintaining the public interest since the issue here is more than merely one of the nationality of the business.

3.4.4 Golden Shares

The introduction of golden shares became allowable according to Japan's corporate law in May 2006. However, the Tokyo Stock Exchange had at that time declared companies issuing golden shares to be inappropriate for listing in the interest of maintaining equality of shareholders. At the same time, it is allowable as long as certain conditions are met, mainly that "in order to avoid contradiction with national policy, when shares with power of veto are issued, the government is named in shareholder allocation."[22] Currently, the only company listed on the TSE with golden shares is INPEX Corporation, a company which is involved in international oil and gas exploration.

3.4.5 Public Corporations

In the case of areas for which maintaining the public nature of the operation is important, one approach is to make said operation a public owned corporation. In Japan, there are seven types of business operations which are declared to be covered by the Local Public Enterprise Act. These are waterworks, industrial water service, railroads, motor transportation, railway service, electricity, and gas. Additional areas in accordance with financial regulations are hospitals and businesses as established by local governments. Motor transportation businesses being carried out under the stipulations of the Local Public Enterprise Act are bus services and railway services including subways and streetcars.

The Local Public Enterprise Act does not recognize monopolization, but rather is for the purpose of regulating corporations operated by local businesses. In addition to these, there are also numerous private companies doing business in the same fields. However, in some rural areas there are not enough private sector companies doing business to provide necessary services. For this reason public entities are tasked with providing basic services for everyday life.

In Japan, most waterworks and sewage operations are publicly run businesses (as of FY2012 99.5% of the population was supplied water by a public entity. As of FY2013 91.3% of the population had its sewage handled by a public entity. Ministry of Internal Affairs and Communications, "FY2013 Local Public Enterprise Yearbook"). The Water Supply Act recognizes market entry by private sector companies, and as in the case of the Railway Business Act, retains the public nature of operations through individual business laws. For a private sector business to enter the market, the authorization of the Minister of Health, Labour and Welfare, along with the consent of the municipality where water is to be supplied is required.[23] In addition, various regulations are implemented in order to avoid situations where the water supply is cut off.

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[22] The Tokyo Stock Exchange considers shares equivalent to golden shares to be shares with power of veto, and companies issuing such shares are in principle disqualified from listing. However, "if the stock exchange recognizes that there is little danger of infringement on the interests of other shareholders or investors based on the purpose of the company's business, the purpose of issuing shares with power of veto, and the attributes of persons or entities to whom shares are allocated and nature of rights as well as other conditions, an exception can be made for allowing the issuance of said type of shares. Entities which may conform to said requirements include corporations which have been privatized and whose corporate activities should not contradict national policy, and for this reason issue shares with power of veto which are allocated to the government." (The Tokyo Stock Exchange, 2014 New Listing Guidebook, 1st and 2nd Sections, Pg. 77)

[23] According to Article 6 of the Water Supply Act, "entities attempting to operate a waterworks business must obtain the authorization of the Minister of Health, Labour and Welfare. (2) Waterworks businesses shall in principle be operated by local governments. If a private entity attempts to carry out waterworks business in the locality, it must first obtain the consent of the local government. Only in the case where said consent has been obtained may a waterworks business be operated."

On the national level, there are cases where certain business operations are required to accept government ownership of 100% of all stock shares. These include Japan Expressway Holdings and Debt Repayment Agency, as well as the Japan Railway Construction, Transport and Technology Agency, both of which take the form of independent administrative agencies.

4. Entry of Foreign-Owned Corporations into Japan's Market and its Effects: Trade Friction and Pressure to Open Markets

4.1 Liberalization of Membership on Tokyo Stock Exchange

Broadening of membership on the Tokyo Stock Exchange

As inward securities investment increased in Japan, the demands on the part of foreign securities companies to obtain membership on the Tokyo Stock Exchange grew louder. Foreign-owned securities companies obtained the right to become members of the Tokyo Stock Exchange in 1971 when the Securities and Exchange Act was revised, but actual membership only became possible when the articles of incorporation of the TSE were revised in 1982. Even then, the maximum number of members allowable remained fixed, hence in reality it was still not possible to gain membership.

Meanwhile, the New York Stock Exchange opened its membership to foreign-owned securities companies in 1977 and the US subsidiaries of Japan's major securities companies gained membership at the beginning of the 1980s (Nomura Securities in 1981 and Daiwa Securities in 1982). American securities companies then began pushing harder for membership on the TSE, saying that not granting membership to foreign companies was unequal treatment.[24] When former US President Ronald Reagan visited Japan in 1983, talks took place as a means of moving toward improvement of financial friction between the US and Japan. Then, in 1984, the US-Japan Yen-Dollar Committee publicized its first report in which one of the demands made to Japan was to open up membership in the TSE. It is said that the opinions of the US Secretary of the Treasury at that time, Donald Regan, former Chairman of Merrill Lynch, were especially important on this point.

In 1984, then Minister of Finance, Noboru Takeshita, requested that the number of members allowable on the Tokyo Stock Exchange be expanded. The decision to increase the number of members on TSE was finally made in 1985, and memberships were granted to six foreign-owned securities companies (four US firms and two UK firms). Another 16 foreign-owned companies gained membership in 1987 after repeated visits to Japan by various foreign dignitaries, including Undersecretary Howard of the UK Department of Trade and Industry and a group of congressmen from the US. Three more memberships were added in 1990.

During the time that TSE membership was expanding in 1987, two of the foreign securities firms which had applied did not gain acceptance. These were both UK firms. Prime Minister Margaret Thatcher demanded that these two firms be granted membership when Prime Minister Noboru Takeshita visited England.[25] However, there was no more space left on the exchange floor. If membership were to expand any further it would be necessary to enlarge the space. Finally, in 1990, more space became available as the number of issues being traded with the use of system trading increased. The third round of membership expansion then took place, allowing three UK firms, including the two which had originally been turned down, to gain membership.

There was also a request from the UK to grant recognition to entry into the securities business by the Japanese branch of one of the British banks. At that time Japan maintained the separation of banking and securities, and so this was not recognized. Membership on the Tokyo Stock Exchange was also limited to the Japanese branches of foreign securities companies. Hence European banks taking the

[24] Memberships on the New York Stock Exchange are individual memberships. In order for a securities company to engage in trading on the trading floor it is required to purchase ten individual memberships. Memberships on the Tokyo Stock Exchange are corporate memberships, and once one corporate membership has been purchased, the number of individuals allowed on the trading floor could be ten or even fifteen. (Meeting minutes of the 101st National Assembly Committee on Finance, May 9, 1984.)

[25] Meeting minutes of the 112th National Assembly Committee on Finance (May 13, 1988)

form of universal banking were not allowed membership. The government of the UK then suggested to the Japanese government that if the Japanese branches of foreign banks were not allowed to engage in securities business, then based on the principle of reciprocity, the banking licenses of Japanese securities companies in the UK might not be recognized. (At that time the subsidiaries of Japanese securities companies in the UK were in the midst of applying for licenses to engage in the banking business.) For this reason, Japanese subsidiaries of foreign securities firms with under 50% ownership held by foreign banks were allowed to obtain licenses to engage in the securities business in 1985. This opened the way for foreign banks to gain membership in the Tokyo Stock Exchange.

In 1999 the Tokyo Stock Exchange discontinued the use of a trading floor, instead carrying out all trading activities electronically. At the same time this did away with the issue of space limitations and hence limits on the number of members which could be accepted. In 2001 the TSE changed from the old membership system to that of a corporation and memberships were exchanged for stock shares. The requirements of subscription and qualification as a trading participant were thrown out, and the current approach began.

4.2 Foreign-Owned Financial Institutions Enter Japan Securities Business

4.2.1 Passage of Act Concerning Foreign Securities Companies and Subsequent Trends in Market Entry

There were three major steps required in order for foreign securities companies to enter the Japanese market. These were (1) Open a representative office in Japan, (2) Establish a branch, and (3) Establish a local Japanese subsidiary or participate in management of an existing Japanese domestic securities company. During the first step of opening a representative office in Japan the company cannot yet engage in actual securities business, and is limited to collecting information on Japan and other activities for the purpose of carrying out business in the future, but on the other hand, it is easy to establish a representative office. This was the most common starting point for entry into the Japanese market up until the 1970s.

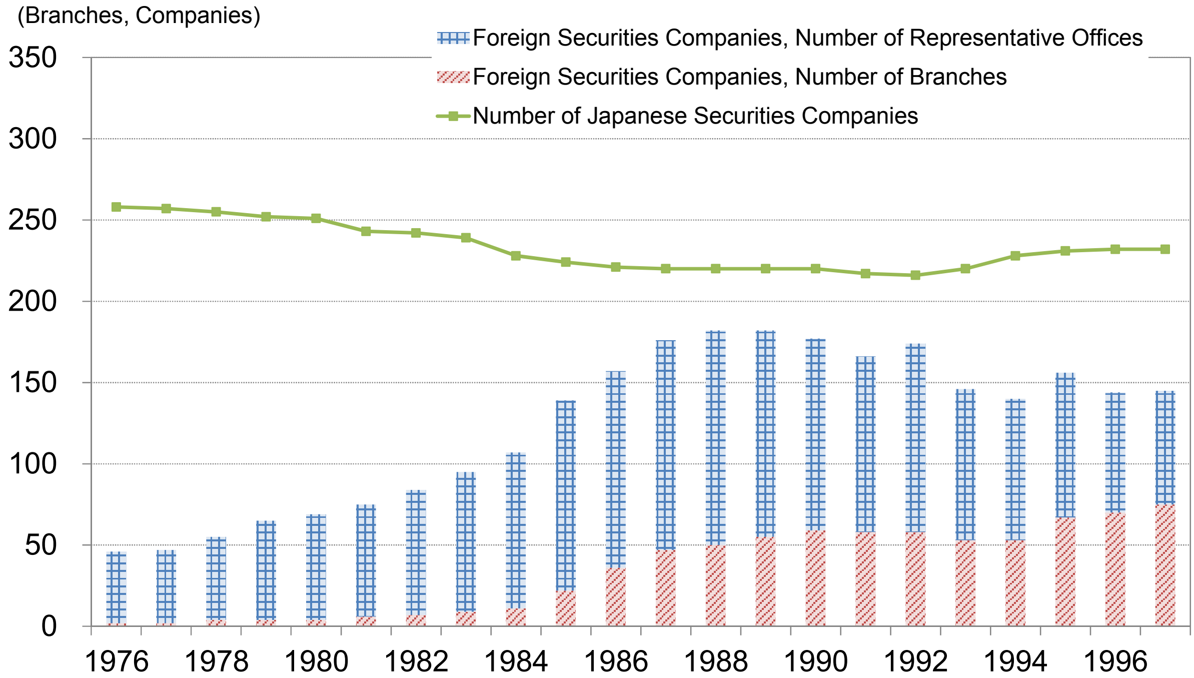
Establishing a branch had no special limitations according to the Act Concerning Foreign Securities Companies or the Foreign Exchange Act, but at the same time, the Securities and Exchange Act does not assume the establishment of branch offices by foreign securities companies. Hence in reality, it was still impossible to do so until 1971 when the Law Concerning Foreign Securities Firms was implemented. This law provided a policy framework according to which foreign securities firms could establish branch offices in Japan. Merrill Lynch became the first foreign securities firm to open a branch in Japan in 1972. Others followed, though there was a limited number, with only four companies and five branches in existence as of the year 1980. At the time, banks were not allowed to engage in the securities business in Japan, and therefore European banks, which basically engage in universal banking, were unable to penetrate the Japanese market. As was mentioned earlier, arguments for the opening of membership in the Tokyo Stock Exchange included demands from the UK to grant approval for membership of Japanese branches of foreign banks as well. Japanese subsidiaries of foreign securities firms with under 50% ownership held by foreign banks were allowed to obtain licenses to engage in the securities business in 1985. Entry into Japan’s market through the opening of branches in Tokyo increased considerably after that point. Then in 1993, the Financial System Reform Act made it possible for mutual entry into Japan’s market on the part of subsidiaries in a different business category, and the limitation on percentage of ownership by foreign banks in subsidiaries in the securities business was discontinued. Meanwhile, though it was required for each branch of a foreign securities firm to apply separately for licensing, but then the securities business changed from a licensing system to a registration system in 1998 in accordance with the Financial System Reform Act and only registration of the main branch was required (hence making application by each branch separately unnecessary).

As for the third step mentioned above, establishing a local Japanese subsidiary or participating in the management of an existing Japanese domestic securities company through investment, this became possible at least in part in 1970 when the securities business was designated as a 50% liberalized industry in accordance with the revision of the Foreign Investment Law. This was called phase 3 of liberalization at that time and liberalized foreign ownership included securities investment trust management companies, securities agencies, and investment advisory companies. In 1973 phase 5 liberalization allowed for 100% ownership by a foreign firm. Meanwhile, in 1993 when the Financial System Reform Act was implemented, entry into Japan's market on the part of subsidiaries in a different business category became possible, but it was 1998 by the time a company entered the market in this form. The first was Merrill Lynch Japan Securities. Merrill Lynch had been doing wholesale business in the past at its Japanese branch, and then in 1998 took over the Yamaichi Securities operation when that company made the decision to close its business. The Merrill Lynch purchase included taking on Yamaichi's 2,000 employees and 28 branches, and allowed it to enter the retail securities business. However, it took time to adjust the range of assets taken over by Merrill, and during that time many former Yamaichi Securities customers shifted their assets to different companies. Then in 2001 the main office of Merrill Lynch was destroyed in the 9/11 terror incident which destroyed the Twin Towers in New York. After that point the company pared down its global expansion, reducing the number of its branches and personnel between 2001 and 2002. The company continued its operations oriented toward high-net-worth individuals and small businesses. Then in 2006 it merged with the Mitsubishi UFJ Financial Group to form Mitsubishi UFJ Merrill Lynch PB Securities with plans to carry out retail securities business, but then sold its share of the business to the Mitsubishi UFJ Financial Group in 2012, thereby withdrawing from the retail business.

There have been many cases in which foreign securities firms have entered the Japanese market by opening up a branch in accordance with the former Act Concerning Foreign Securities Companies. However, the revision of Japan's Corporate Law in 2006 allowed a large number of foreign-owned securities firms to enter the market, including Goldman Sachs, Deutsche Securities, and Credit Suisse, by making their former branches into Japanese subsidiaries.[26] New entries often also took the route of establishing a Japanese corporation.

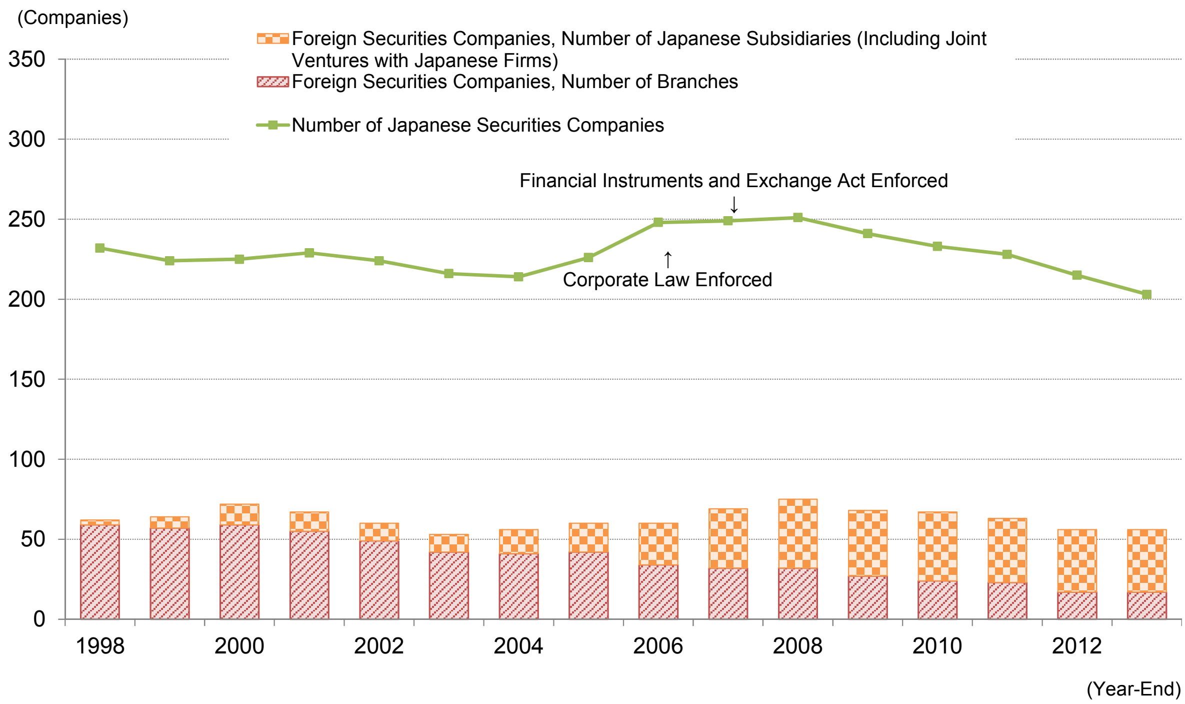
[26] Article 821 of Japan's Corporate Law stipulates that in regard to companies established under the laws of foreign countries, companies with their main office in Japan or whose purpose is mainly to carry out business in Japan (heretofore referred to as pseudo-foreign companies) cannot continuously carry out trading in Japan. In the past, one of the common ways in which foreign-owned companies entered Japan's market was to establish a subsidiary in the Cayman Islands or Hong Kong, and open a branch of that corporation in Japan. This is probably the type of situation referred to as a pseudo-foreign company. The interpretation of this situation by the Ministry of Justice is that it does not hamper or impede normal trade already being carried out in Japan. However, in consideration of the legal risk involved with doing business in this way, many foreign securities firms have changed their way of doing business from a branch to the formal establishment of a Japanese corporation.

Change in the Number of Securities Companies through 1997 — Chart 8



Source: Ministry of Finance (Ministry of Finance Securities Bureau Yearbook), Securities Annual Report Editorial Board (Securities Annual Report); compiled by DIR.
Note: Figures are as of end December through 1995, then in 1996 as of end June, and in 1997 as of end July.

Change in the Number of Securities Companies since 1998 — Chart 9



Source: Financial Services Agency (Financial Services Agency Annual), Japan Securities Dealers Association (Securities Industry Bulletin); compiled by DIR.
Note: Data source after year 2007 limited to members of the Japan Securities Dealers Association.

4.2.2 Entry of Foreign-Owned Companies into Asset Management Market

During the postwar period, Japanese securities companies also engaged in investment trust management business as a sideline, but then due to the argument that in consideration of the beneficiary's profit it would be best to operate this area as a separate business, securities companies set up independent consignment companies for this purpose between 1959 and 1961. However, as time passed no new entries into the market on the part of companies other than the original consignment subsidiaries set up by the big securities companies were occurring. This situation continued, so that for some time, all members of the Securities Investment Trust Association were subsidiaries of domestic securities companies. Gradually interest increased in Japan's investment trust market on the part of not only foreign-owned companies, but domestic banks and insurance companies as well. For this reason the Ministry of Finance started up a study group on investment trusts in 1988, and in 1989 published a report entitled, "The Future of Investment Trusts: Suggested Improvements from the Viewpoint of the Investor." In this report, the opinion was expressed that more companies, whether foreign-owned or domestic, should enter the investment trust market assuming they are appropriately set up to operate an investment trust. In response, the Ministry of Finance published another report entitled, "Licensing Standards for Investment Trusts." In response to this encouragement, the first foreign-owned investment trusts obtained licenses in 1990. These were Warburg Investment Trust, Jardine Fleming Investment Trust, and Invesco MIM Investment Trust (renamed MIM Investment Trust as of 1990).

Standards for licensing were reviewed in 1992 at which time conditions for obtaining a license considered to be barriers to entry into the market on the part of foreign-owned companies were removed. (Specifically, the requirement that the applicant must already have experience operating an investment trust in Japan was eliminated.) At the same time, banks and insurance companies were also allowed to enter the market via whatever corporate group they were a member of. Meanwhile, another barrier to the entry of foreign-owned companies was that consignment companies were not allowed to carry out sales, so in 1993, the carrying out of direct sales on the part of investment trust consignment companies was finally recognized. Then in 1998 banks and other registered financial institutions were allowed to carry out over-the-counter sales. As of 2005 some post offices were allowed to carry out sales, and at the same time, the sales networks of foreign-owned consignment companies expanded.

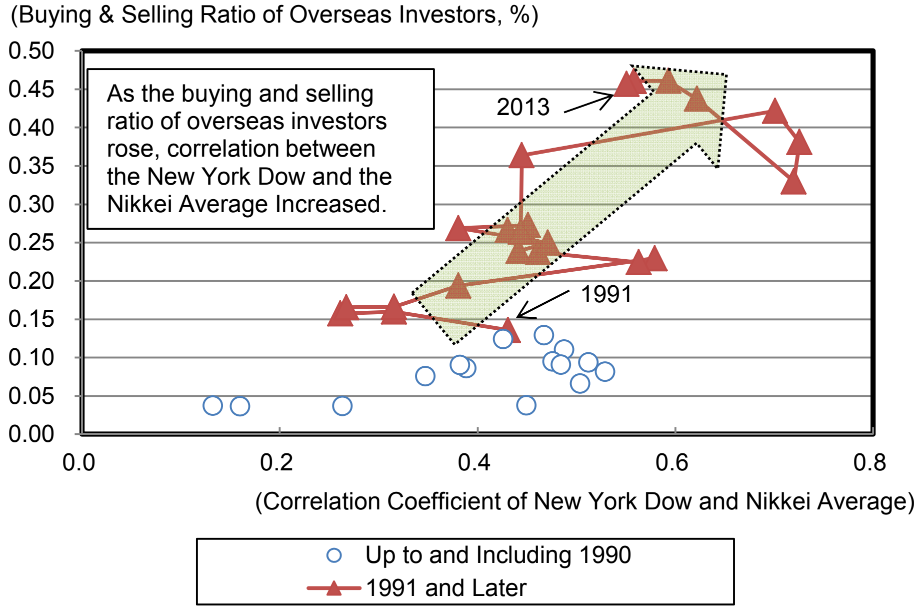
4.2.3 Entry of Foreign-Owned Companies into the Securities Market

There are a variety of things which one can say the Japanese securities market itself has benefited from as a result of the entry of foreign capital into the market. For the market in general and for the middleman, there has been more efficient price formation, while a more diverse population of investors entering the market has brought a broader range of opportunities for revenue growth due to the introduction of new methods of trade. Meanwhile, for issuing companies, there are a number of benefits, one of which is the ability to procure capital in overseas markets without any of the problems which used to be associated with that activity.

On the other hand, there are a few disadvantages as well. One is the outflow of income to other countries, while another is unstable employment in the financial industry due to the shorter business cycle of foreign firms in comparison to Japanese corporations, which also means the possibility of restructuring or even the sudden decision to pull out of the market. The entry into the market of traders who seek excessive profitability could even upset the stability of the market overall.

Additionally, once the entry of foreign capital into the market has progressed, linkage with overseas markets becomes much closer, meaning that risk increases that the domestic market will be negatively affected if there is a global financial crisis. Meanwhile, close linkage with world markets could in some cases reduce the attractiveness of the market to some investors due to the reduction in arbitrage opportunities.

Buying and Selling Ratio of Overseas Investors and Japan – US Market Correlation Chart 10



Source: Nihon Keizai Shimbun, Haver Analytics; compiled by DIR.

5. Transitions in Regulatory Administration

5.1 Change and Reform in Regulatory Regime[27]

5.1.1 The Securities and Exchange Commission 1947-1952

During the postwar period in Japan, the organization with overall regulatory responsibility for the securities industry was the Securities and Exchange Commission established in July, 1947 in accordance with the Securities and Exchange Act. There were only three members on the Securities and Exchange Commission's administrative committee set up as an external agency of the Ministry of Finance. Chairman Kohei Tokuda (former president of the Japan Stock Exchange) and two committee members – Shozo Shimasue (former member of the board of the Bank of Japan) and Kuninosuke Fujita (former Chief of Trading of the Ministry of Commerce and Industry).

When the commission was first established, it was not given the same power and authority carried by the US Securities and Exchange Commission (SEC) tasked with enforcing the US Securities and Exchange Law. Instead, it was limited to the role of an administrative body which carried out investigations and deliberations regarding policy associated with enforcement of the law as well as other important subjects. The Ministry of Finance set up a separate Securities Bureau for actual enforcement of the law. However, when the Securities and Exchange Law was completely revised in April, 1948, the Securities and Exchange Commission was made into an independent government authority under the jurisdiction of the Finance Minister as a means of strengthening its authority, thereby giving it the power to establish rules and regulations.

Japan's Securities and Exchange Commission was initially a small agency in comparison to the SEC in the US, but even so, it boasted some major achievements during its time, including establishment of a stock exchange using a membership system, reopening of the stock market after the war, implementation of a margin trading system, supervision of securities companies, and the fostering and improvement of a system of corporate disclosure. At the same time however, the independence of the Securities and Exchange Commission tended to hinder coordination and cooperation with other administrative bodies. Hence it was abolished in August 1952 along with most other administrative commissions (with the exception of the Japan Fair Trade Commission and the National Personnel Authority) when Japan's system of administrative commissions was overhauled.[28]

5.1.2 The Ministry of Finance 1952-1998

Jurisdiction of securities administration was shifted over to the Financial Bureau of the Ministry of Finance (a different organization from the current-day Ministry of Finance) when the Securities and Exchange Commission's jurisdiction over securities administration came to an end in August 1952. Later it was shifted to the Securities Bureau when it was established in June 1964. Meanwhile, the Securities and Exchange Council, associated with the Ministry of Finance, was established. Its function was limited to acting on the behest of the Ministry of Finance regarding investigations and deliberations regarding the issuing and trading of securities.

During the latter part of the 1950s, with the economy in favorable condition and the stock market brisk, policy on securities administration as carried out by the Ministry of Finance tended toward allowing

[27] References cited: *Japan Securities History 2*, Ed. Hiromi Arisawa (Nihon Keizai Shimbun, May 1995), *Financial Regulation and Compliance*, by Akiko Karaki (Japanese Institute of International Business Law, "International Business Law Vol. 30", 2002), *Financial System Reform – a Fifty Year Trajectory*, by Yoshimasa Nishimura (Institute for Financial Affairs, March 2011), *Legal Sources of Financial Regulatory Systems and Means of Enforcing (3)*, by Naohiko Matsuo (Institute for Financial Affairs, "Financial and Legal Affairs No. 1847", October 2008).
[28] *Japan Securities History 2*, Ed. Hiromi Arisawa (Nihon Keizai Shimbun, May 1995), pg. 93.

the industry independent self-governance when it came to questions of overall business activities.[29] The only requirement was the registration system for securities companies. But then, with the stock market being so active, “the stock market expanded and rapidly became more appealing to the general public. When the small, individual investor became more common, problems occurring between customers and securities companies also increased.”[30] For this reason, the Ministry of Finance provided corrective guidance to securities firms regarding investment solicitation. In some cases registration was revoked and even business operations halted. Between the time the registration system was first established and the end of FY 1964, there was a cumulative total of 1,569 securities companies registered to do business. Of these, registration of 338 companies was revoked for reasons such as failure to make payments and violation of the law. A total of 718 companies were forced to close down their business.[31] Even so, customer (investor) protections were still insufficient considering the ease with which a securities company could be established under the registration system, which required only that certain requirements be fulfilled.

The securities industry had become quite active due to the favorable economy, but then the business situation went downhill after the tight-money policy was introduced in June 1961, and a shakeout ensued. Until that time securities companies had been expanding the scale of their businesses, including opening more branch offices and increasing the number of employees, but their financial conditions rapidly worsened due to the economic slowdown. In 1963 there was a securities market slump, and in May of 1964, the former Yamaichi Securities collapsed, causing a securities depression. For this reason the securities business registration system was changed to a licensing system as of April 1967. The purpose of the new system was not only to protect investors, but to prevent excessive competition amongst securities companies, as well as to bring more stability to the securities industry through the fostering of a commitment to professionalism amongst the remaining securities firms. A restructuring of the securities industry then ensued,[32] also providing the opportunity for reform. In addition, the shift to a licensing system also changed the approach to securities administration. Rather than handling issues after they occurred, administrative guidance was now oriented toward preventing problems.

The licensing system continued until after Japan’s economic bubble burst in the 1990s, at which time a complete revamping of the administrative guidance system took place. But until that time, the Ministry of Finance tended to be oriented toward protecting existing industry members by limiting competition. In other words, a protective administrative guidance system was operated, which worked like an armed convoy. The protective system limited competition between different types of business as well as within the industry. Its purpose was to prevent financial institutions from going bankrupt. Specifically, securities companies were not allowed to carry out specialty business, while banks were prohibited from operating a securities business (though certain exceptions were made). Through regulatory limitations on who could carry out what kind of business, a rigid separation was established between securities and banking.[33] Meanwhile, competition within the industry was also strictly limited. There was a fixed commission system used by the entire industry, while interest rates offered by banks were

[29] *Japan Securities History 2*, Ed. Hiromi Arisawa (Nihon Keizai Shimbun, May 1995), pg. 137.
[30] *Japan Securities History 2*, Ed. Hiromi Arisawa (Nihon Keizai Shimbun, May 1995), pg. 137.
[31] *Japan Securities History 2*, Ed. Hiromi Arisawa (Nihon Keizai Shimbun, May 1995), pg. 205.
[32] The new licensing system, operating under strict listing criteria, meant that could take as much as three years to obtain a license. As of October 1964 there was a total of 559 securities companies in Japan. This number was reduced to 279 by the day licensing went into effect. (The registrations of 27 companies were revoked, while 108 companies went out of business, 24 merged with other companies, and 120 others underwent transfer of business.) Of the total of 302 companies applying for licenses as of September 1967, 24 withdrew their applications and 3 were refused licenses. As a result, as of April 1, 1968, there were only 275 licensed securities firms. *Japan Securities History 2*, Ed. Hiromi Arisawa (Nihon Keizai Shimbun, May 1995), pg. 208.
[33] The ban on banks operating a corporate bond business was lifted in 1981.

also fixed. Interest rates were set at a level which would not cause businesses with limited competitiveness to fail.[34]

The reason for restricting competition both between different types of business in the financial industry and within the same field of business was the fact that the Japanese government placed the highest importance on maintaining stability in the financial markets. It did so by cultivating and protecting financial institutions as a means of maintaining a stable and sufficient supply of capital to industry.[35]

The Ministry of Finance operated its administrative guidance function by acting as a supervisor of the industry. The idea was to provide direction before unfair or dishonest practices or other management problems occurred on the part of securities companies. Administrative guidance focused mainly on making a broad use of notifications which would be sent whenever the bureau chief felt it necessary. This personal approach was preferred over the reliance on documented laws and regulations alone. Meanwhile, the securities companies made use of personnel tasked with handling the Ministry of Finance who would carry out detailed negotiations on various topics as a means of gaining a fine grasp of the ministry's intentions. The tendency was to discuss business and management issues before they became a problem and to come to a mutual understanding with the authorities.

However, this method of preventive administrative guidance carried out as necessary was opaque as far as outsiders to the system were concerned. Under the preventive method of administrative guidance, the role of monitoring for the purpose of discovering violations of rules was neglected, so the job of keeping a watch out for unfair business practices was insufficient. Moreover, under the preventive method of administrative guidance the securities companies developed a dependence on the authorities, thereby failing to develop their own sense of responsibility in these matters. Companies had no sense of resolving problems of their own initiative, and management was carried out in a rather passive way. These problems were exposed in a rather symbolic fashion in 1991 when a major securities scandal was discovered. This was the turning point which led to a total revamping of the administrative guidance system.

Details of a securities scandal were broadcast on June 1991 revealing the extent to which the practice of compensating certain major customers for losses had spread amongst members of the securities industry. It was also disclosed that some securities companies were involved with organized crime, attracting heightened criticism from the public. In response to these developments a debate ensued regarding measures to prevent a recurrence of the problem. As an emergency measure the law was revised so that compensation for losses and discretionary account transactions were forbidden. In addition, the inspection and monitoring mechanism was revamped in order to establish a better way to deal with the root cause of the problem. It was argued that Japan needed to establish a securities and exchange commission with the same independence and strength of authority held by the SEC in the US as a means of ensuring the oversight required to uphold fairness and transparency in the securities market. However, the Ministry of Finance was very much against this idea, and government action was limited to the carrying out of organizational reforms within the ministry, setting up a new agency working under the Ministry of Finance called the Securities and Exchange Surveillance Commission. The commission was made semi-independent from the Ministry of Finance and was given the authority to carry out inspections. Hence it was significant in terms of providing the market with a better system of inspections.

In addition to the arguments described above, debate mounted in the early 1990s regarding the need to review the centralization of fiscal and financial administration all in one government body – in other

[34] *Financial Regulation and Compliance (2)*, by Akiko Karaki (Japanese Institute of International Business Law, "International Business Law Vol. 30, No. 2", 2002), pgs. 159-160.
[35] *Financial Regulation and Compliance (2)*, by Akiko Karaki (Japanese Institute of International Business Law, "International Business Law Vol. 30, No. 2", 2002), pg. 159.

words the Ministry of Finance. During the entire period during which the liberalization of finance and the internationalization of capital progressed in Japan, the Ministry of Finance handled not only fiscal issues such as the budgeting process, but also administrative guidance of the financial and securities industries all on its own. But by the 1990s the argument that the ministry could no longer sufficiently handle the changes brought on by a new era in which the financial markets were expanding and related needs had become more diverse grew louder along with criticisms that the Ministry's method of carrying out administrative guidance was discretionary and lacked transparency. In response to these criticisms, institutional reforms were implemented according to which fiscal responsibilities and financial administration were separated. This brought about fundamental changes in financial and securities administration.

5.1.3 The Financial Services Agency (Formerly the Financial Supervisory Agency) 1998 to Present

The Ministry of Finance retained jurisdiction over financial investigations and inspections, as well as planning and proposals until the year 2000.

Establishment of the Financial Supervisory Agency

When arguments surrounding the separation of fiscal issues from financial administration came to a head with the securities scandal of 1991, change was limited to institutional reforms within the Ministry of Finance. However, criticisms regarding the Ministry's handling of administrative guidance again came to the surface in 1995 when public funds were used to invest in a housing loan company. Here again, the arguments surrounding separation of fiscal and financial administration issues arose. Discussion then took place within the government and the party in power at that time, and in December 1996, the government submitted a bill to the Diet which would reform the system of financial administration. This piece of legislation would shift inspections and supervisory functions overseeing private sector financial institutions to a newly established agency – the Financial Supervisory Agency. The fiscal planning function would be left to the Ministry of Finance. The result was the passing of the Financial Supervisory Agency Establishment Act in June 1997. The law was enforced in June 1998 at which time the new Financial Supervisory Agency was inaugurated. Inspections and supervision of financial firms would now be performed separately from the Ministry of Finance by the new Financial Supervisory Agency.

Reorganization: the Financial Services Agency

Until this time restructuring of the financial administration mechanism took place only in the form of internal reforms in the Ministry of Finance, but arguments regarding the need to restructure the governing system itself, meaning complete reform of the administrative guidance system across the board and restructuring of the central government ministries and agencies themselves had begun to intensify. This lead to further review of the financial administration mechanism. The Basic Act on Central Government Reform was passed in June 1998, restructuring the central government ministries and agencies so that the old structure changed from the Cabinet Office plus 22 ministries and agencies to the Cabinet Office plus 12 ministries and agencies. The restructuring of the central government ministries and agencies was implemented in January 2001, while six months earlier in July 2000, the Financial Supervisory Agency was reorganized, becoming the new Financial Services Agency. At the same time, the planning function associated with finance which had been under the jurisdiction of the Ministry of Finance when the Financial Supervisory Agency was first set up was also shifted over to the new Financial Services Agency. Meanwhile, in January 2001, the Financial Reconstruction Commission, which had handled bankruptcies of financial institutions and crisis management since

December 1998, was abolished. These functions were also shifted to the new Financial Services Agency.[36]

Meanwhile, the Ministry of Finance was reorganized and recast as a new ministry (English language name unchanged), with its duties limited to handling the government budget and financial statement, and tax system. However, it would still share jurisdiction over bankruptcies of financial institutions and crisis management with the new Financial Services Agency, and due to shared jurisdiction, it was decided that the Financial Services Agency would reside within the Ministry of Finance.

The sequence of events as described above led ultimately to the establishment of the current supervisory system.[37]

The shift to after-the-fact monitoring

As time passed and increasing change and reform came to the financial administration mechanism, the fundamental approach to financial and securities administration also changed from the advance prevention approach used before Japan's economic bubble collapsed, which focused primarily on maintaining a dialogue between government agencies and private corporations, to after-the-fact monitoring and inspections once the economic bubble finally burst. Behind this change was another shift in focus whereby the financial administration process began to place more importance on protecting the market (i.e. the investor) rather than financial institutions in hopes of maintaining a stable financial system. The shift to protecting the market itself and the investor meant a newfound concern with transparency and fairness.

Since the 1990s, due to the influence of the economic downturn which occurred after Japan's economic bubble collapsed, the problem of bad debt (or non-performing loans) held by financial institutions became increasingly serious. During this time pressure from overseas to further liberalize its markets also increased, and Japan's financial market became increasingly liberalized as a result. In the securities industry liberalization of brokerage commissions began in April 1994, starting with large transactions and gradually extending to other types of transactions from there. Liberalization of this area was complete by October 1999. During the same period, regulations limiting involvement between different types of business, which were meant to restrict competition between different aspects of the financial industry, were relaxed. The major topic covered was the entry of both banks and securities companies into the same market, which banks would usually do by establishing a subsidiary to pursue a different aspect of the financial business. This was allowed as of 1993 with the implementation of the Depository Institutions Deregulation and Monetary Control Act. Then in 1997, the entry of subsidiaries owned by the same holding company into the same area of business was also allowed. At first, the handling of equity products by subsidiaries of banks was not allowed. There were various restrictions on business carried out by subsidiaries in a different area of business from the parent, but as of 1999, the limitation on the range of business subsidiaries could engage in was discontinued. Meanwhile, in 1998 the regulation limiting securities companies to sticking to their specialty was abolished, and the securities industry changed from a licensing system to a registration system. Due to the influence of the economic downturn, financial liberalization, and the introduction of the principle of competition, a financial administration system operating as if it were an armed convoy was no longer tenable.[38]

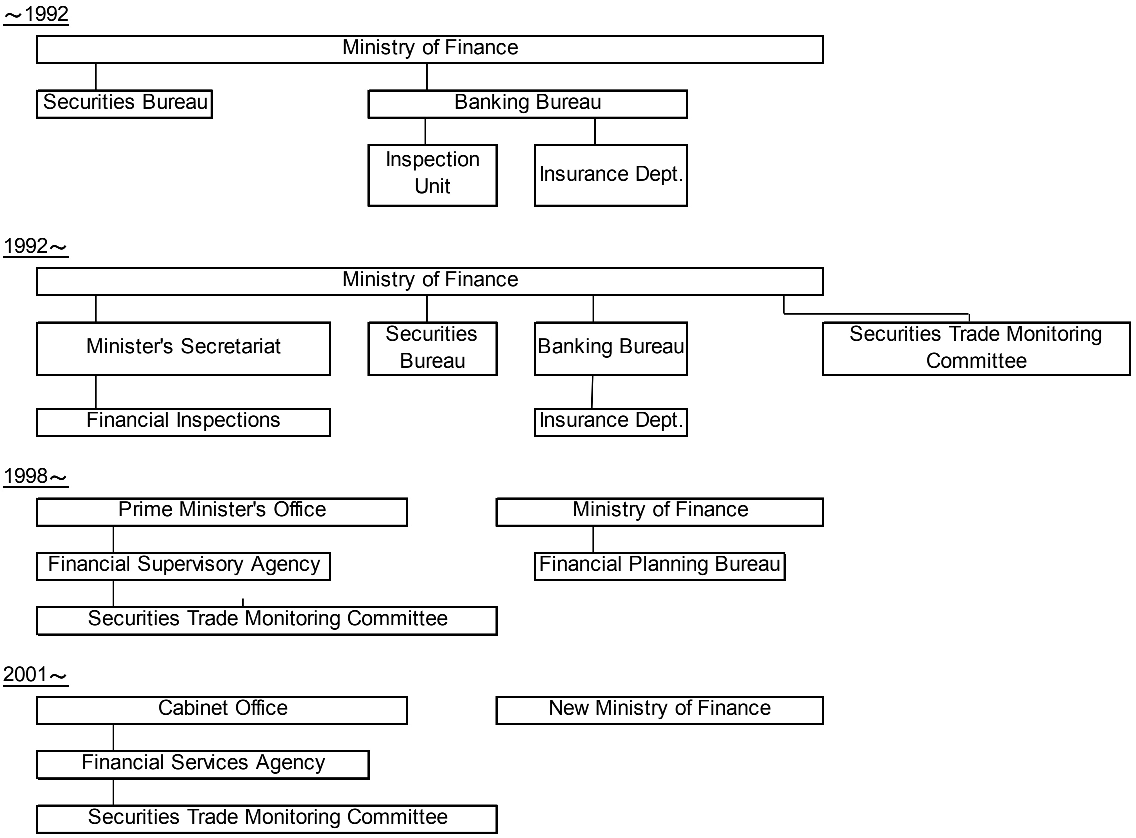
[36] *Financial System Reform – a Fifty Year Trajectory*, by Yoshimasa Nishimura (Institute for Financial Affairs, March 2011), Pgs. 467-468.

[37] To be precise, as of April 2004 the Certified Public Accountants and Auditing Oversight Board was set up under the jurisdiction of the Financial Services Agency, forming the financial administration system as it currently exists.

[38] *Financial Regulation and Compliance (4)*, by Akiko Karaki (Japanese Institute of International Business Law, "International Business Law Vol. 30, No. 4", 2002), pgs. 472-473.

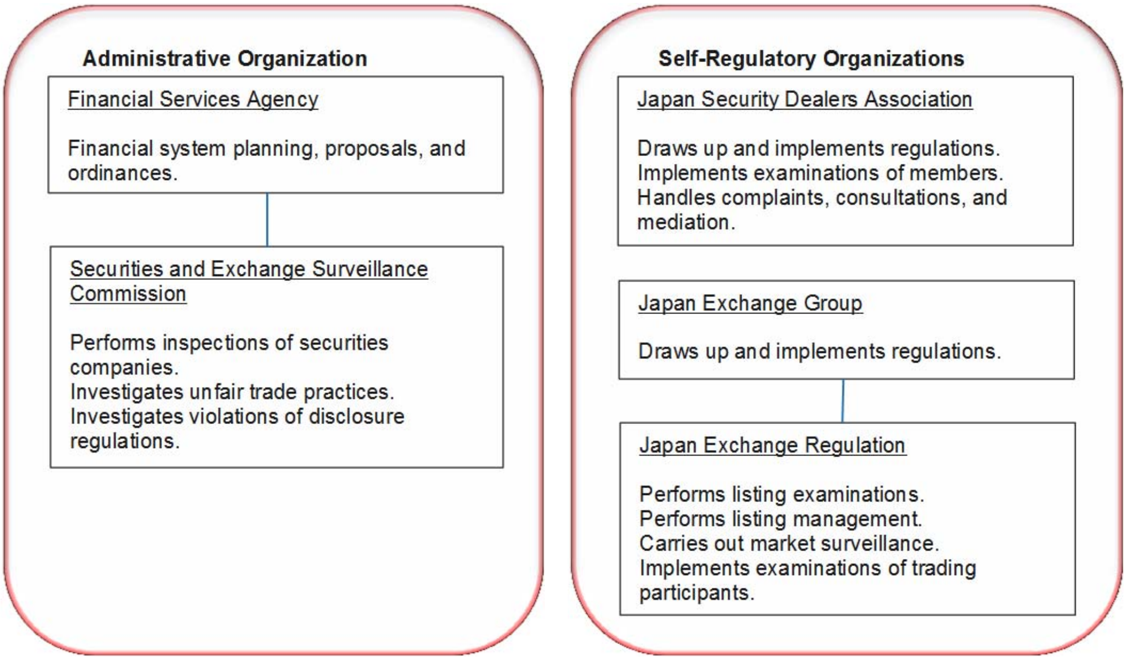
As these changes occurred, the method of supervision used by the financial and securities administrative authorities changed from one focusing on administrative guidance to one based on inspections. The government was now aiming at a transformation in financial administration where the old method of operating administrative guidance by the Ministry of Finance, which was now deemed discretionary and lacking in transparency, would be reformed and in its place would be a system based on transparency and fair rules. The administrative guidance approach focusing on advance prevention was officially scrapped in June 1998 when the Ministry of Finance announced that it would discontinue financial related notifications. The bulk of notifications were abolished and instead the government began to rely more on ordinances and legal notices. New guidelines were published to provide instructions for employees working in administration and said guidelines were made public. Later, administrative guidance was stopped completely. Meanwhile, in regard to inspections, efforts were made to strengthen the administrative framework oriented toward obtaining a better grasp of the actual financial conditions of financial institutions, due to the seriousness of bankruptcies amongst financial institutions and the mounting problem of bad debt. Efforts toward establishing a system of detailed inspections and monitoring were promoted. This completed the transformation of financial and securities administration to after-the-fact monitoring.

Major Transformations in Japan’s Financial Regulatory Regime — Chart 11



Source: Financial Services Agency; compiled by DIR.

Japan’s Current Regulatory Regime in the Securities Market — Chart 12



Source: Produced by DIR.

5.2 Change in Approach to Supervising Foreign-Owned Financial Institutions

Since the 1990s with the shift in method of supervision from advance prevention to after-the-fact monitoring and surveillance, the approach to how foreign-owned financial institutions were supervised also changed.

Supervision as carried out by the Ministry of Finance until the 1990s focused on discretionary administrative guidance, and the system of inspections was, for lack of a better term, nominal at best. Especially in the case of foreign-owned companies for which MOF had no personnel placed in charge, opportunities for communication in which the authorities might be able to initiate a dialogue on various issues were rare. It is assumed that the Ministry's administrative guidance in this case was a one-way street. Moreover, violations of legal ordinances, regulations and ministry notices on the part of foreign-owned companies were not monitored closely. Most of the 150 foreign-owned companies doing business in Japan at that time never underwent an inspection even once.[39] Foreign-owned companies were basically left to their own devices.

We can only assume that the approach to supervision on the part of the Japanese authorities differed between domestic and foreign-owned companies. It is likely that what led to this is the fact that there were few foreign-owned companies in the domestic market during the era in which the focus of financial administration was more on the protection of domestic financial institutions. Moreover, during this same time, the process of determining which foreign-owned companies would be allowed entry into the domestic market was a highly selective one. It is thought that this resulted in slack supervision and inspections where foreign-owned firms were concerned. It is possible that this led to a weakening of motivation amongst foreign-owned firms to set up their own in-house compliance systems.

A turnaround occurred in the handling of foreign-owned firms during the latter part of the 1990s when the effects of the collapse of Japan's economic bubble became especially severe. During this time the government's system of inspections and administrative guidance became increasingly strict. Some major examples include the following. In 1999, the bank license of Credit Suisse First Boston Group (CSFB) was revoked due to the sale of financial products which involved the covering up of its clients' actual financial condition. Then in 2002, ten foreign-owned securities companies were ordered to suspend business due to violations of regulations on short-selling. In 2004 Citibank's business license was suspended.

The administrative disposition in regard to the CSFB Group was the result of an on-site inspection carried out by the Financial Supervisory Agency in January of 1999. The result was announced later in the year in July. Government actions included the revoking of the banking license of the Tokyo Branch of Credit Suisse Financial Products (CSFP), the halting of certain new business operations of Credit Suisse Trust & Banking Ltd., and administrative orders to improve business operations of the group, mainly in the form of strengthening the group's compliance system. The Financial Services Agency stated in its decision regarding the CSFP Group that the company "took actions which are in violation of the Banking Act and other laws and regulations, including the attempt to interfere with or avoid an inspection, as well as the carrying out of actions considered to be damaging to the public interest, such as continuously and on a regular basis carrying out the high volume composition and providing of financial products considered to be particularly inappropriate in view of proper disclosure of its customers' financial conditions." In addition, the Financial Services Agency found Credit Suisse Trust & Banking Ltd. also to be guilty of the carrying out of actions considered to be damaging to the public interest, as well as the attempt to interfere with or avoid an inspection. In regard to the group as a whole, the Financial Services Agency found violations of other laws, as well as insufficient internal

[39] *Financial Regulation and Compliance (3),* by Akiko Karaki (Japanese Institute of International Business Law, "International Business Law Vol. 30, No. 3", 2002), pg. 321.

management and compliance systems. After announcing the administrative disposition in regard to the CSFB Group, the Financial Services Agency ordered multiple foreign-owned companies to suspend business due to the sale of products for which losses are postponed. The punishment of these other companies was much more severe than for the CSFB Group, most likely due to the fact that in addition to the existence of products for which losses are postponed, the companies were also guilty of the attempt to interfere with or avoid an inspection.[40]

Administrative dispositions in regard to violations of regulations on short-selling on the part of foreign-owned securities companies were carried out between late 2001 and early 2002. In December of 2001 the Tokyo branch of Goldman Sachs was found to be in violation of short-selling regulations leading to the suspension of a portion of its operations for a period of ten days. The situation at Goldman Sachs prompted the Financial Services Agency to carry out a comprehensive investigation of short-selling with the help of the Japan Securities Dealers Association. In-house inspections were carried out regarding observance of short-selling regulations, as well as inspections and interviews performed by the Securities and Exchange Surveillance Commission. Inspections personnel were increased and private sector experts were also used as a means of bolstering the monitoring capabilities of the Securities and Exchange Surveillance Commission. These efforts resulted in the suspension of business operations of the Tokyo branch of Morgan Stanley Securities for a period of five weeks announced in February of 2002. By March of that same year similar administrative dispositions were brought against ten more securities companies, nine of which were foreign-owned. Since these decisions focused especially on foreign-owned companies many complained and demanded that details of the investigation be disclosed.[41]

As for the City Bank incident of September 2004, administrative disposition included the following actions. The business operations of private banking (PB) departments at Japanese subsidiaries (including the Marunouchi Branch, the Nagoya local office, Osaka local office, and the Fukuoka local office) were suspended, and licenses revoked a year later (with business to be closed within the year). Meanwhile, new transactions in the area of foreign currency deposits in private banking departments were suspended for a period of one month and improvements in internal management were ordered including more thorough compliance. The reason given by the Financial Services Agency for such severe actions including the revoking of licenses was that fundamental problems were found in both compliance and governance. Multiple issues were indicated, including those falling under the category of actions considered to be damaging to the public interest, specifically the providing of large amounts in financing to the defendant in a securities market manipulation case and the providing of fake loans to this same individual in order for said individual to acquire public funds from a local government, bringing the bank under suspicion of legal violations, namely money laundering. These actions fall under the category of neglect in business transactions. Meanwhile, the bank was also found guilty of violations including failure to explain risk involved in certain financial products and inappropriate exchange of customer information with an overseas subsidiary, which may have been used for the purpose of intentional adjustment of settlements. These actions all fall under the category of the composition and execution of inappropriate transactions. Moreover, the bank was also found to have failed to follow previous instructions from the government to improve its business practices (August 2001) and had not made any attempts at finding means of resolving fundamental problems at that time. Although these administrative dispositions touched upon violations of multiple laws and unfair business practices, the government was concerned that actions it took could become a diplomatic issue.

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[40] *Financial Regulation and Compliance (7)*, by Akiko Karaki (Japanese Institute of International Business Law, "International Business Law Vol. 30, No. 7", 2002), pg. 950.

[41] The Nikkei, "Regulations on Short-Selling Tested; Foreign Bias, Rush to Comply with Law" (Nihon Keizai Shimbun, April 10, 2002).

Even so, the Financial Services Agency brought harsh penalties against the bank because it wanted to deliver a clear message that "deregulation should not ignore the interests of the investor."[42]

Looking at these examples of administrative dispositions we can see that there were multiple instances of severe punishments in the early 2000s ranging from suspension of business operations or worse levied against foreign-owned financial institutions, while during the same period there were few administrative dispositions levied against domestic institutions. This brought on accusations of bias against foreign firms.[43] However, examples of dispositions against major domestic financial institutions increased after this point, allowing the Financial Services Agency to uphold its reputation for equal treatment of domestic and foreign firms. The criticisms quieted down after a while and the agency as continued to this day with no incidents.[44] Meanwhile, in March 2007 the Financial Services Agency published its standards for administrative dispositions in a document entitled "Administrative Action in the Financial Sector." With this publication the Financial Services Agency gain recognition for its transparency in financial administration.

The discovery of numerous violations of laws and regulations on the part of foreign-owned companies may have resulted in a loss of trust for the market, but at the same time these incidents created the opportunity for the Financial Services Agency to demonstrate its fairness in carrying out financial supervision of both domestic and foreign firms. The appearance of these problems ultimately led to improvements in fairness and transparency of administrative guidance. There is always the possibility that especially severe administrative dispositions levelled against foreign firms could lead to diplomatic problems, but as long as there is fairness and transparency, and no bias against foreign firms, recognition of the validity of said decisions can help to avoid any problems. In this sense it is very important to make the rules clear in advance and strictly carry out the supervision and inspection of the compliance status of financial firms. At the same time, if rules are overly strict or overly formal, there is a risk that the handling of financial institutions could become routine and passive. Initiating a dialogue with the financial institution in advance is the most desirable approach, since this will more likely encourage the company to take proactive measures on its own so as to avoid problems. It is also important to take the cost of administrative guidance into consideration and to carry out the verification process in a timely and appropriate manner.

[42] The Nikkei, "Financing the Wealthy – Citibank Abuses Deregulation: Financial Services Agency Administrative Dispositions (Opinion)" (Nihon Keizai Shimbun, September 21, 2004).
[43] *Legal Sources of Financial Regulatory Systems and Means of Enforcing (3)*, by Naohiko Matsuo (Institute for Financial Affairs, "Financial and Legal Affairs No. 1847", October 2008), Pg. 46.
[44] *Legal Sources of Financial Regulatory Systems and Means of Enforcing (3)*, by Naohiko Matsuo (Institute for Financial Affairs, "Financial and Legal Affairs No. 1847", October 2008), Pg. 46.

6. Development of the Market and its Influence

6.1 Development of the Bond Market and its Liberalization (Samurai Bonds and Euroyen Bonds)

The development of the bond issuance market and its liberalization is a major topic in the opening up of Japan's capital market to foreign participants. This is especially so for the bond issuance market where international capital flows occur. In this chapter we look back at the history of Japan's bond market and its liberalization, focusing on samurai bonds and Euroyen bonds.

6.1.1 Establishment of the Market and Deregulation

(1) 1970: Public offerings of yen-denominated foreign bonds established

The first yen-denominated bond (also known as Samurai Bonds) was issued by the Asian Development Bank in December 1970. However, due to the relative immaturity of Japan's capital market at that time, 80% of bond subscriptions were left up to the bank to handle on its own, in reality making the issue more like a private placement. In 1971 the World Bank issued its first yen-denominated bond with bank purchase of its own bond limited to one third of the total. Terms of issue were left up to the prevailing forces of the market (market value), making this an actual public issue.

As the issuance of yen-denominated foreign bonds continued, the needed developed for clearer issuance standards. The "Ordinance Regarding Notification of Subscriptions or Sale of Foreign Bonds, etc." was enacted in April of 1972. In May of the same year, the government stated that "In order to promote the export of capital, acquisition of securities listed on foreign markets by residents shall be liberalized, while at the same time efforts should be made to smoothly issue yen-denominated bonds of blue-chip issues which have established an international reputation, such as international organizations and foreign governments, through the development of the bond market." In response to this statement, domestic underwriters produced a list of issuance standards. In these standards a preference was expressed for issuers such as international organizations which Japan was affiliated with or which had a close relationship with Japan, and foreign governments, governmental organizations and agencies, regional governments, and foreign corporations having sufficient experience in issuing bonds on the international capital markets and which had established a good reputation. The basic standard for selection of an issue was that an issuer must have a performance record of having issued bonds on the US international capital market at least three or more times over the past five years, or at least five times or more over the past twenty years. As for the method of determining terms of issue, this was to be taken into consideration by the underwriter and the issuer separately for each issue based on market forces and rating and evaluation on overseas markets. After the World Bank bond was listed on the market in April of 1973, its distribution yield became one of the standards for bond listings.

(2) 1972: Private placements of yen-denominated foreign bonds established

Private placements of yen-denominated foreign bonds issued for a small number of specified institutional investors began in November 1972. Based on public offerings of yen-denominated foreign bonds, private placements were thought of as being complementary, and in principle were used in cases where making a public offering would be difficult, including (1) Creditworthiness and (or) name recognition of the issue would make a public offering difficult, and (2) Issuance of a public offering would be institutionally impossible in the case of particular regional governments or government agencies. In addition, disclosure in accordance with the Securities and Exchange Act was considered to be unnecessary for private placements since administrative guidance already limited purchase to institutional investors with knowledge and experience in securities investment. There was also a restriction on resale whereby resale could not take place for the first two years after purchasing privately placed bonds.

(3) Establishment of the non-resident Euroyen bond market and easing of restrictions associated with expansion of the yen-denominated foreign bond market

Establishment of the non-resident Euroyen bond market:
As internationalization of Japan's economy progressed, demand for utilization of the yen overseas grew stronger. Issuance of Euroyen bonds by non-residents was first recognized in 1977. (The ban on issuance by residents was lifted in 1984.) Before 1977 under the Foreign Exchange Act issuance of Euroyen bonds was possible as long as one obtained authorization. However, no explanation of how to apply was made available, so issuance was rare. In March 1977 the Ordinance of the Ministry of Finance on invisible trade was partially revised, making it possible for non-residents to issue Euroyen bonds.

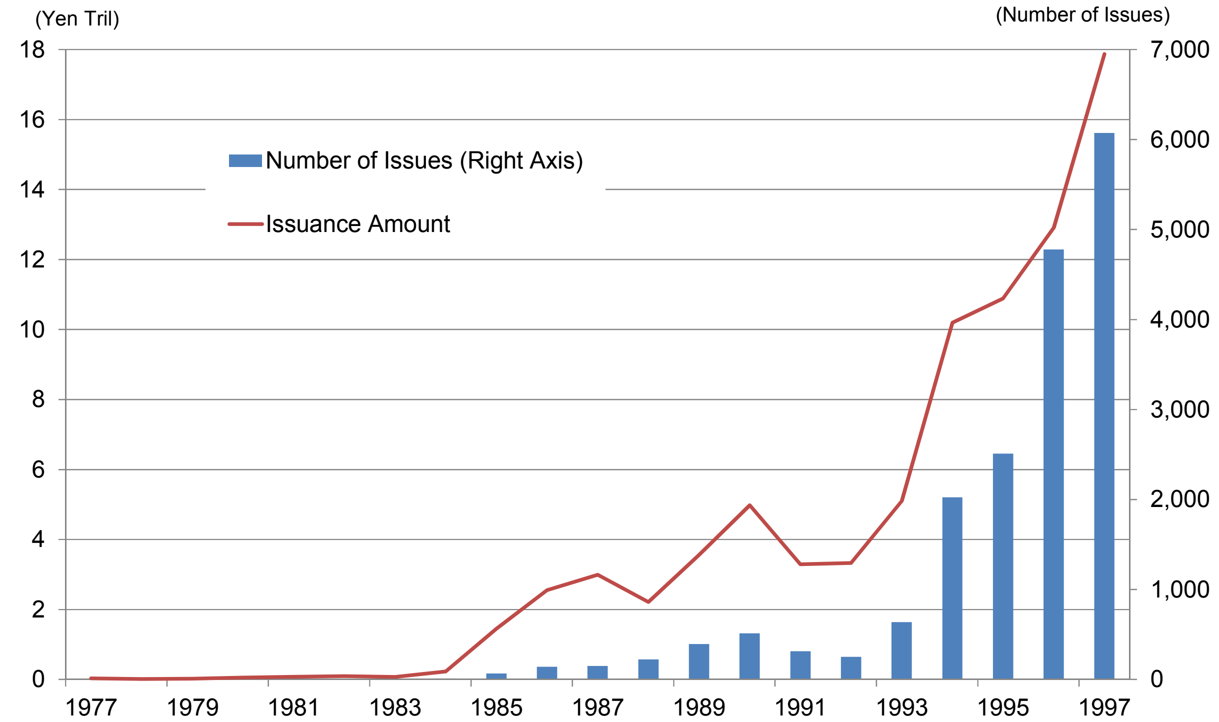
Issuing bodies were limited to international financial institutions with experience issuing yen-denominated bonds on the Tokyo market, and only one or two issues per year were carried out. The Ministry of Finance issued the following statement in regard to the role of lead manager: "The lead manager on Euroyen bond issues must be a Japanese securities company, and the fiscal agent must be a Japanese bank. This is the consensus." In addition, a restriction period of 180-days was put into place during which time the bond issue was not allowed to flow back to Japan.

The opinion of the Ministry of Finance regarding Euroyen bonds at the time was published in its International Finance Bureau Annual Report. The ministry was still taking a cautious approach to Euroyen bonds – "Unlike yen-denominated foreign bonds issued on the Tokyo market, there is no outflow of capital affecting the international balance of payments. They are neutral in regard to transfer of funds, and come in handy as a means of internationalizing the yen. But on the other hand, if the number of issues of Euroyen bonds were to grow very large, it could have a negative effect on the foreign exchange market." For this reason the Finance Ministry insisted that the Tokyo market be made the main market for issuance of yen-denominated bonds by non-residents, and Euroyen bonds were limited to a complimentary role.

In May of 1977 the first Euroyen bond was issued by the European Investment Bank. The issuance amount was 10 billion yen with a nominal interest rate of 7.25% and maturity of 7 years. Since it was the first Euroyen bond to be issued, subscriptions significantly exceeded the issuance amount.

By March of 1979 requests on the part of foreign governments to issue Euroyen bonds had increased, so limitations on who could issue Euroyen bonds were loosened somewhat to include foreign governments which could meet certain requirements (the issuer should have a performance history of having issued yen-denominated bonds in Japan at least three times, have a high rating in the US and Europe, and a close relationship with Japan in the area of international affairs and economically). Expansion of the range of acceptable issuers increased the pace of issuance to 4-5 issues per year.

Non-Resident Euroyen Bond Issuance Amounts and Number of Issues Chart 13



Source: Ministry of Finance, International Finance Bureau Annual Report; compiled by DIR.

Easing of restrictions associated with expansion of the yen-denominated foreign bond market: During the latter part of the 1970s, the desire for more capital outflow from Japan was on the rise in response to low domestic interest rates and a significant trade surplus. This led to the rapid expansion of the yen-denominated foreign bond market. In order to better deal with new developments, the Ordinance for Enforcement of the Securities and Exchange Act was revised in order to make the market mechanism more flexible while at the same time revising the tax system. Until that time, various problems associated with issuing a bond were handled separately for each bond issue, but revision of the ordinance changed the market mechanism so that information regarding plans for issuance and issue schedule would be exchanged in advance between securities companies acting as lead-managers as well as opinions on said issues. Meanwhile, issue standards were also relaxed so that the requirement regarding performance record was changed – issuers were now required to have experience of issuing bonds at least two times over the past five years rather than the older requirement of having issued bonds at least three times over the past five years. Moreover, it was allowable for one of these past issues to have been a private placement. In the area of taxes, yen-denominated foreign bonds would now be eligible for the same taxation as small-sum tax exempt savings. These changes also had the effect of expanding the range of issues acceptable. In the past, issuance was restricted to government bonds and regional bonds of foreign countries, but now it would be possible for foreign corporations to issue yen-denominated bonds as well (corporations were still required to have a government guarantee from their home country). This requirement was relaxed further in 1978 when the system of taxation was revised, so that the government guarantee was no longer required for foreign corporations to issue yen-denominated bonds. At the same time, the revision of the Ordinance for Enforcement of the Securities and Exchange Act allowed the extension of the submission deadline for financial statements listing securities holdings associated with the continuous disclosure obligation, as well as exemption from the obligation to submit interim and extraordinary reports in special cases. (The change here entailed the relaxation of criteria by which a company could be recognized as being a special case.)

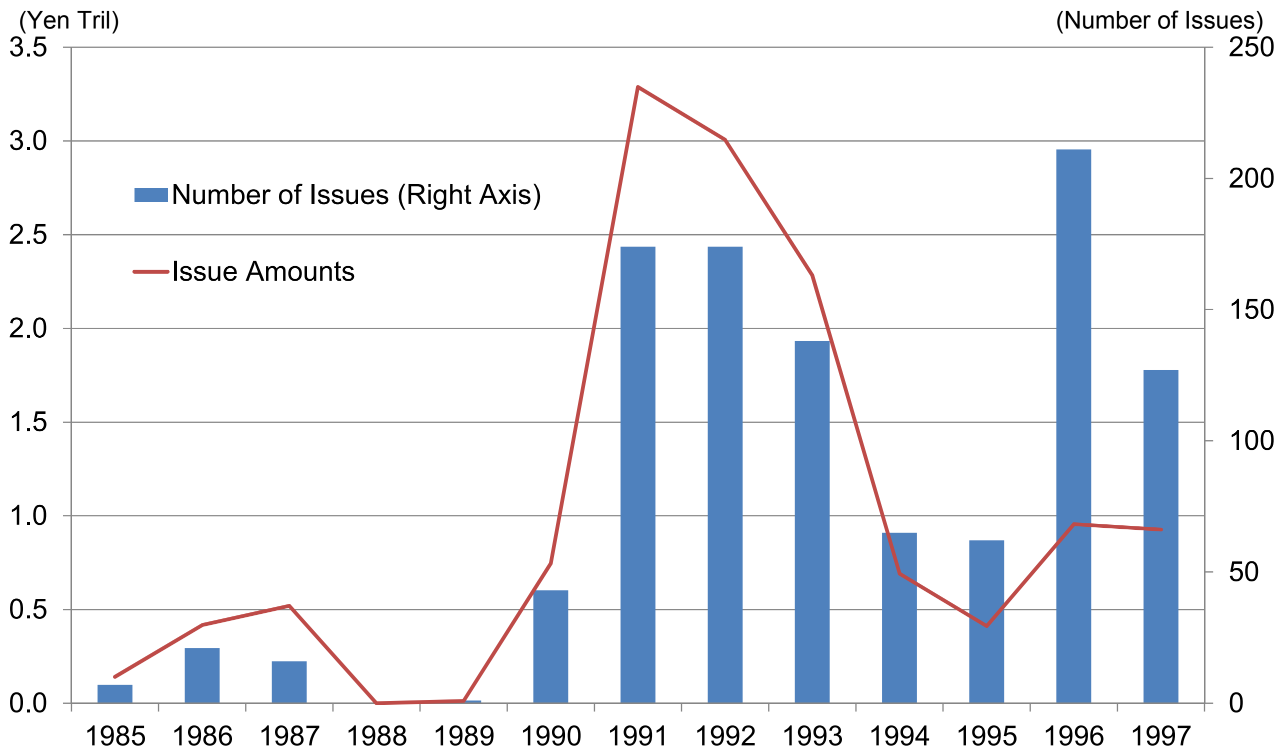
Deregulation continued to advance step by step after this point, so that by 1981 a whole new system of setting terms of issue was adopted (the older presale method was changed to the indication method) and restrictions on yen-denominated foreign bond holdings by institutional investors was relaxed. In 1983, a quarterly issuance program was introduced and the restriction on the number of issues allowable per quarter was thrown out.

(4) April 1984: Establishment of resident Euroyen bond market

Issuance of Euroyen bonds by residents was first recognized in 1980, but this was limited to private placements on the Middle East markets for the purpose of bringing in oil money. Five bonds totaling fifty billion yen were issued between 1980 and 1982, but then issuance was broken off when oil-producing countries saw their capital beginning to dry up.

As a part of general efforts to promote the internationalization of the yen, issue standards were set in response to the Japan-US Summit and then Minister of Finance Takeshita and US Treasury Secretary Regan’s joint press conference in November of 1983. Issuance became possible as of April 1984 under these issue standards, with a backflow restriction period of 180-days. However, Euroyen bonds issued by residents were not eligible for benefits under the Special Taxation Measures Law, so even if a bond holder were a non-resident, they were still charged Japanese withholding tax on interest income. Because of this problem there were no issues in 1984. But then the system of taxation was revised in response to the meeting of the US-Japan Yen-Dollar Committee as part of the general effort to promote internationalization, and as of April 1985, and measures were adopted so that non-residents would not be taxed when purchasing resident Euroyen bonds as long as said bonds were held for a period of five years or more. This encouraged the resumption of Euroyen bond issues by residents.

Issue Amounts and Number of Issues of Resident Euroyen Bonds **Chart 14**



Source: Ministry of Finance, International Finance Bureau Annual Report; compiled by DIR.

(5) May 1984: US-Japan Yen-Dollar Committee triggers rapid deregulation

By the beginning of the 1980s the strong dollar – weak yen trend leading to the growing trade deficit in the US was being problematized in American public opinion. The weak yen was also pointed out as being one of the causes of the closed nature of Japan’s financial and capital markets. The US-Japan Yen-Dollar Committee was established in November 1983 when former US President Ronald Reagan visited Japan. Then, in May 1984, measures moving toward internationalization of the yen and liberalization of the financial and capital markets were made public. In the committee’s report, a significant easing of restrictions in the Euroyen bond market and liberalization of Japan’s financial markets was suggested, along with more flexible rules regarding yen-denominated foreign bond issues and their management as a means of undergirding the general effort toward liberalization.

Easing of restrictions in the Euroyen bond market:
The cautious approach taken by the Ministry of Finance in regard to Euroyen bonds took an about-face as a result of the report of the US-Japan Yen-Dollar Committee in 1984. After that point the ministry promoted rapid easing of restrictions.

The following issues were raised in the US-Japan Yen-Dollar Committee’s report. (1) Organizations allowed to issue non-resident Euroyen bonds should be expanded to include regional governments, foreign government agencies, and foreign private sector corporations with said change to go into effect as of December 1984. At the same time, the rating used as the issue standard should be changed from AAA to A (foreign private sector corporations would still have to fulfill other requirements to meet the issue standard for yen-denominated foreign bonds), and the regulation regarding number of bond issues placed in the past and issue amount should be abolished. (2) Issue standards to be met by foreign private sector corporations in order to issue non-resident Euroyen bonds should be further eased by April 1985, and (3) Foreign-owned companies should be allowed to act as lead manager on Euroyen bond issues based on their past experience as well as Japanese law as of December 1984.

After the easing of regulations in December 1984, issuance of non-resident Euroyen bonds, especially on the part of foreign private sector companies, grew rapidly, totaling 227 billion yen between April 1984 and March 1985. Then between April 1985 and March 1986 total issue amount grew to 1 trillion 445.7 billion yen.

Easing of regulations associated with non-resident Euroyen bonds took place in stages after this point, including issue standards and backflow restriction, moving according to policies indicated by the US-Japan Yen-Dollar Committee’s report and the March 1985 Foreign Exchange Council report. Upgrading and expanding the form of the product was implemented in 1985 and term limits were abolished in 1989, while issue standards were relaxed and application for authorization to issue bonds under the MTN program was made more flexible. Finally, in 1993, issue standards were completely abolished, and the authorization system for the issuance of Euroyen bonds was thrown out in 1998 and replaced by after-the-fact reporting.

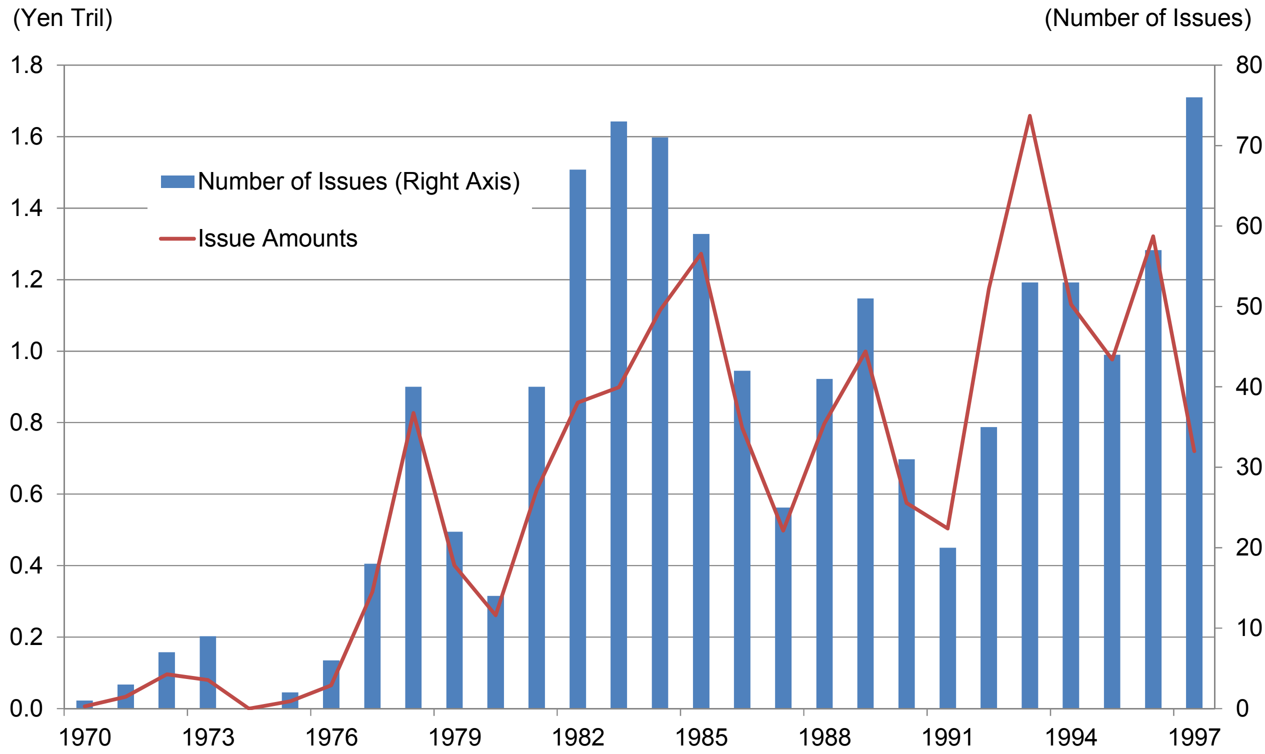
Meanwhile, the system of taxation on resident Euroyen bonds was revised in 1985 as a result of the US-Japan Yen-Dollar Committee report. Then as of April 1985 measures were adopted to make interest income on resident Euroyen bonds received by non-residents tax-free for a period of five years or more. After this point further easing of regulations took place in stages, with issue standards for resident Euroyen bonds completely abolished in January 1996 and backflow restrictions removed in April 1998.

Deregulation of public offerings of yen-denominated foreign bonds:
Easing of regulations associated with yen denominated foreign bonds also took place around the same time as a result of the US-Japan Yen-Dollar Committee report. Details are as follows: (1) Issue standards relaxed: Issue standards on public bonds changed from AAA to A rating, (2) Issue amount per bond increased: International organizations in which Japan is a member, such as the World Bank, less than 3 billion yen, issues with AAA rating less than 2 billion yen, (3) Interval abolished: In the past, a wait period (interval) of two quarters was required before issuing another bond for the same issuer (though an exception was made for international organizations in which Japan is a member). Measures were ultimately adopted to abolish this wait period. However, it was decided that further easing of regulations was desirable from the viewpoint of internationalizing the yen, so in July of the same year, measures were implemented to carry out the following. (1) Further relaxation of issue standards: Issue standards on public bonds changed from AA or more to A rating or better, (2) Issue amount per bond increased further: Issues with A rating also raised to 3 billion yen, (3) Management of issues on a quarterly basis abolished: Measures adopted to accept new issues on a monthly basis.

Easing of regulations continued after that point, and in 1989 term limits (upper limit) were abolished, as well as the limitation on issue lots. In 1996 issue standards were thrown out completely, and in 1998 the advance reporting system was replaced by after-the-fact reporting under the Revised Foreign Exchange and Foreign Trade Control Law. Bonds could now be freely issued.

Deregulation of private placements of yen-denominated foreign bonds:
In capital markets, not only in the United States but all over the world, both public offerings and private placements coexist. Due to this fact, Japan began to rethink the position it had given private placements up to that point as being merely complementary to public offerings of yen-denominated foreign bonds. Measures to liberalize this aspect of Japan’s bond market and to make it more flexible were implemented in March 1986. Regulations were eased in the areas of maximum term of issue (originally 5 or more years but less than 10, changed to 5-years or more with no upper limit), increase of issue lots (from a maximum of 10 billion yen to maximum 30 billion yen). In November of that same year, application of the “one-third rule” was relaxed. In the past, issue amounts of private placements were required to be within one-third the total amount of public offerings. After this point the ruling was made more flexible, with the combined total of both yen-denominated bonds and foreign currency-denominated bonds used instead.

Issue Amounts and Number of Issues of Yen-Denominated Foreign Bonds **Chart 15**



Source: Ministry of Finance, International Finance Bureau Annual Report; compiled by DIR.

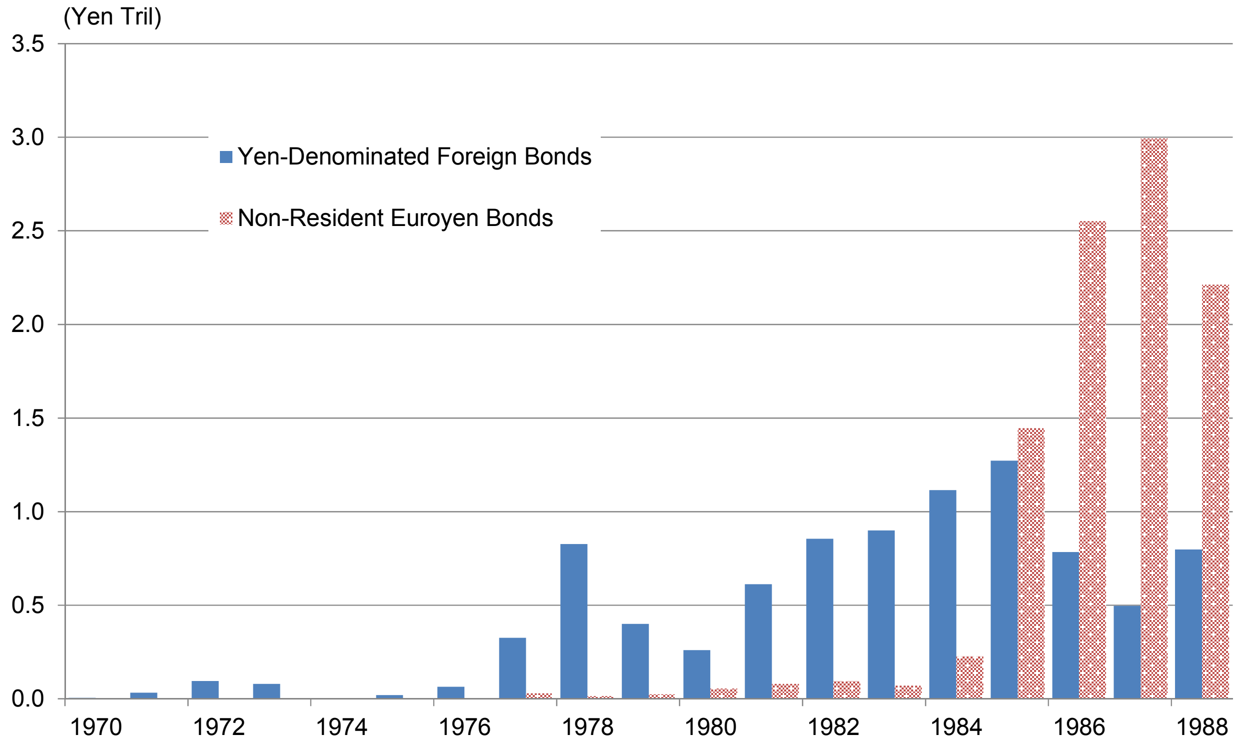
6.1.2 Changes Brought About by US-Japan Yen-Dollar Committee's Deregulation

(1) Shift overseas of demand for bond issues

Increase in issuance of non-resident Euroyen bonds and downturn in yen-denominated foreign bond market:

The easing of regulations in the Euroyen bond market had a direct effect on the yen-denominated foreign bond market. Both markets were deregulated, allowing non-residents to issue yen-denominated bonds, but doing so also made the two markets competitors. Since the decisions made by the US-Japan Yen-Dollar Committee and announced in its official report, regulations associated with the issuance of Euroyen bonds were gradually eased, but in contrast, liberalization of the yen-denominated foreign bond market lagged behind. Issuers of non-resident yen-denominated bonds tended to make use of the Euroyen bond market as an alternative to the yen-denominated foreign bond market due to the lack of flexibility in that market and the amount of time it could take to come out with a new issue. In a comparison of issue amounts on the two markets between April 1984 and March 1985, yen-denominated foreign bonds totaled 1,114.5 billion yen, while non-resident Euroyen bonds totaled 227 billion yen. However, between April 1985 and March 1986, issuance of Euroyen bonds slightly exceeded that of yen-denominated foreign bonds, with yen-denominated foreign bonds totaling 1,272.5 billion yen and non-resident Euroyen bonds totaling 1,445.7 billion yen. In the fiscal year that followed – April 1986 to March 1987 – issuance of yen-denominated foreign bonds totaled 785 billion yen while non-resident Euroyen bonds totaled 2,551.5 billion yen. Annual issuance amount of Euroyen bonds now tripled that of yen-denominated foreign bonds.

Comparison of Issue Amounts of Yen-Denominated Foreign Bonds and Non-Resident Euroyen Bonds
Chart 16



Source: Ministry of Finance, International Finance Bureau Annual Report; compiled by DIR.

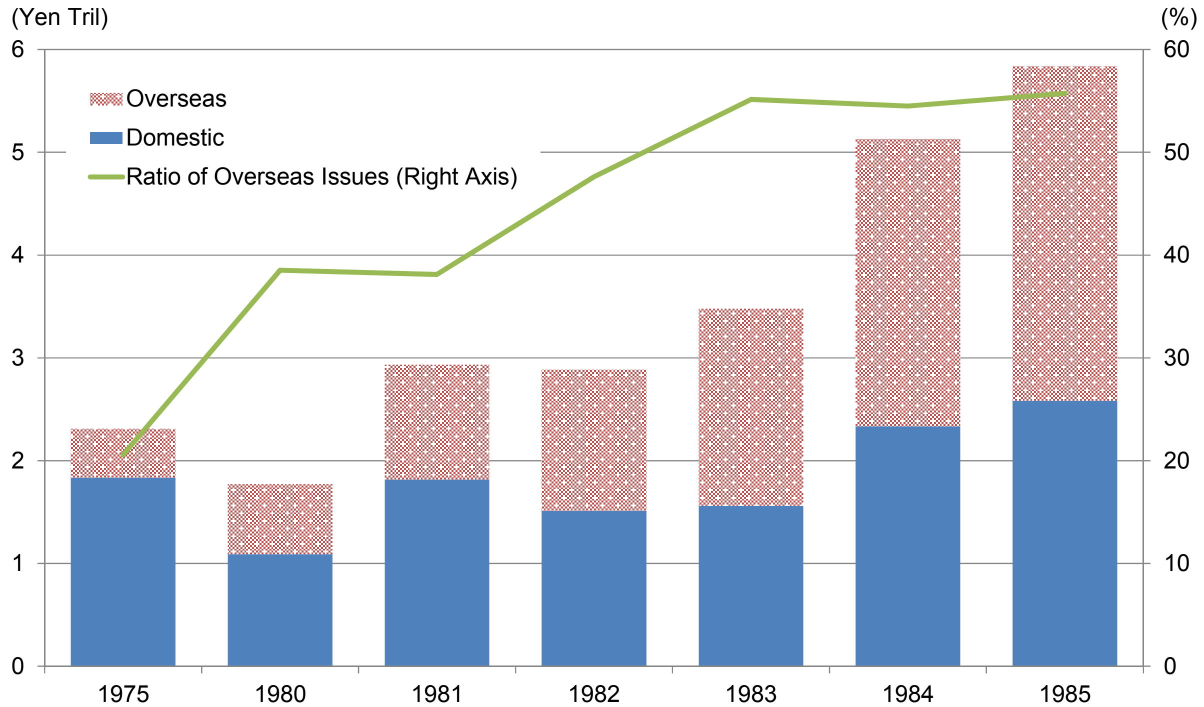
The following systemic problems of the yen-denominated foreign bond market were pointed out: (1) The system of disclosure made quick and flexible issuance difficult, (2) The market was small and lacking in terms of fluidity, (3) It was difficult to carry out dollar swaps, (4) Cost of issuance was on the high side, and (5) As a product the bonds came in only one flavor – plain vanilla, hence somewhat limited in terms of marketability. In response to these problems, the market began to make use of settlement systems in Europe such as Euroclear and Cedel in April 1987 as a means of improving fluidity, and also began issuing Daimyo Bonds. Meanwhile, in 1988, the Securities and Exchange Act was revised, and a shelf registration system was adopted. Measures were also implemented to improve the disclosure system, including the shortening of the disclosure period from 30-days to 15-days, and simplification of the security registration form for issuers meeting certain requirements. Implementing these measures encouraged a temporary comeback for the yen-denominated foreign bond market, but the discrepancy between the total issue amounts on the yen-denominated foreign bond market and the non-resident Euroyen bond market did not shrink significantly.

Hollowing-out of the domestic market:
Beginning in around 1982 the domestic market began to show the effects of a hollowing-out phenomenon as domestic corporations made more and more use of overseas markets for the issuance of bonds. Bond issues of domestic firms on overseas markets reached nearly 50% of the total at this time.

In 1986, the Securities and Exchange Commission submitted a report summing up the findings of its Special Committee on Public and Corporate Bonds regarding the factors leading to the hollowing-out of Japan's domestic bond market. The committee's conclusion was that Japan's domestic bond market was in need of a major overhaul, citing issues such as collateral requirements, an organization according to which bond issues were under the control of the Bond Issuance Board, the trustee system, the lack of diversity in types of corporate bonds, corporate bond issuance limits, and the disclosure system. At that time the basic framework of Japan's domestic bond market was the collateral principle, which required that all corporate bond issues be collateralized. However, collateral requirements meant lots of paperwork and added cost, making issuance of a bond complicated and time-consuming, with a lack of speed and flexibility. This is why Japanese corporations had shifted their bond issuance activity to overseas markets where unsecured issues (without collateral) were the norm. Another problematic aspect of the bond issuance mechanism was the Bond Issuance Board, which was made up of members from trustee banks, securities companies acting as underwriters, and others involved in issuing bonds. The board was an autonomous organization whose role was to draw up the basic framework of bond issues, bring in specific bond issues, and confirm them. The existence of this organization standing at the center of the bond issuance process was linked with batch issues of corporate bonds at the end of each month and a decision-making process which tended toward uniformly standardized terms of issue. This issuance framework with its method of batch issuance made quick and flexible bond issuance difficult. Standardized terms of issue meant inflexible decisions on interest rates. The committee stated in its report that seen from the viewpoint of those outside Japan this system was incomprehensible, and its criticisms eventually led to a review of the system. According to the trustee system, the job of the trust corporation was to set issue standards and redemption periods as well as drawing up the financial covenants. The trust company was involved in a broad range of responsibilities associated with a bond issue. (The subscription trustee would collect bond subscriptions, distribute payments through redemptions, and call the meeting of shareholders, while the collateral trustee would acquire collateral for bondholders and hold it in safekeeping, as well as implementing it as necessary.) One of the problems was that the division of roles between the trustee and the underwriter was extremely vague. The committee's criticism was that Japan's bond issuance framework was incomprehensible seen from the viewpoint of those doing business outside Japan, and that the trustee role was a factor in the high cost of issuing bonds on the Japanese market.

The downturn in Japan's yen-denominated foreign bond market, as well as the hollowing-out of the domestic market was caused by the same factors that led issuers to flee that market and go to the Euroyen bond market instead. Japan's yen-denominated foreign bond market was behind in terms of deregulation and liberalization. The committee was of the opinion that the yen-denominated foreign bond market should be harmonized with the domestic market.

Trends in Issue Amounts of bonds by Japanese Firms on Domestic and Overseas Markets Chart 17



Source: Ministry of Finance, International Finance Bureau Annual Report; compiled by DIR.
Note: Figures are the total of straight bonds, convertible bonds, and bonds with warrants.

(2) Liberalization of lead manager role allowing foreign-owned firms to take on position promotes competition

In the past, the norm was for a Japanese securities company to act as lead manager on both Euroyen bonds and yen-denominated foreign bonds. It was the US-Japan Yen-Dollar Committee which demanded that foreign-owned corporations be allowed to enter the underwriting business as lead managers in this new international bond issue market. Foreign-owned securities companies obtained the right to act as underwriter and lead manager on non-resident Euroyen bonds as of December 1984, and then on resident Euroyen bonds in April 1987.[45]

According to a Nihon Keizai Shimbun article dated March 31, 1984, there was a strong reaction to this decision coming from the Japanese domestic securities industry, which called it “financial liberalization gone too far.” At the time there were still many countries which limited the lead management role on Eurobonds issued in their own currency to their own domestic companies. The UK allowed American securities companies to act as lead manager only on Europound bonds issued by American companies. Meanwhile, the ban on issuance of resident Euroyen bonds was lifted in 1984, and entry of foreign firms into the competition for lead management position on Euroyen bonds was likely to bring a decline in underwriting commission rates. There was a danger that this could effect the level of commissions in the domestic market as well.

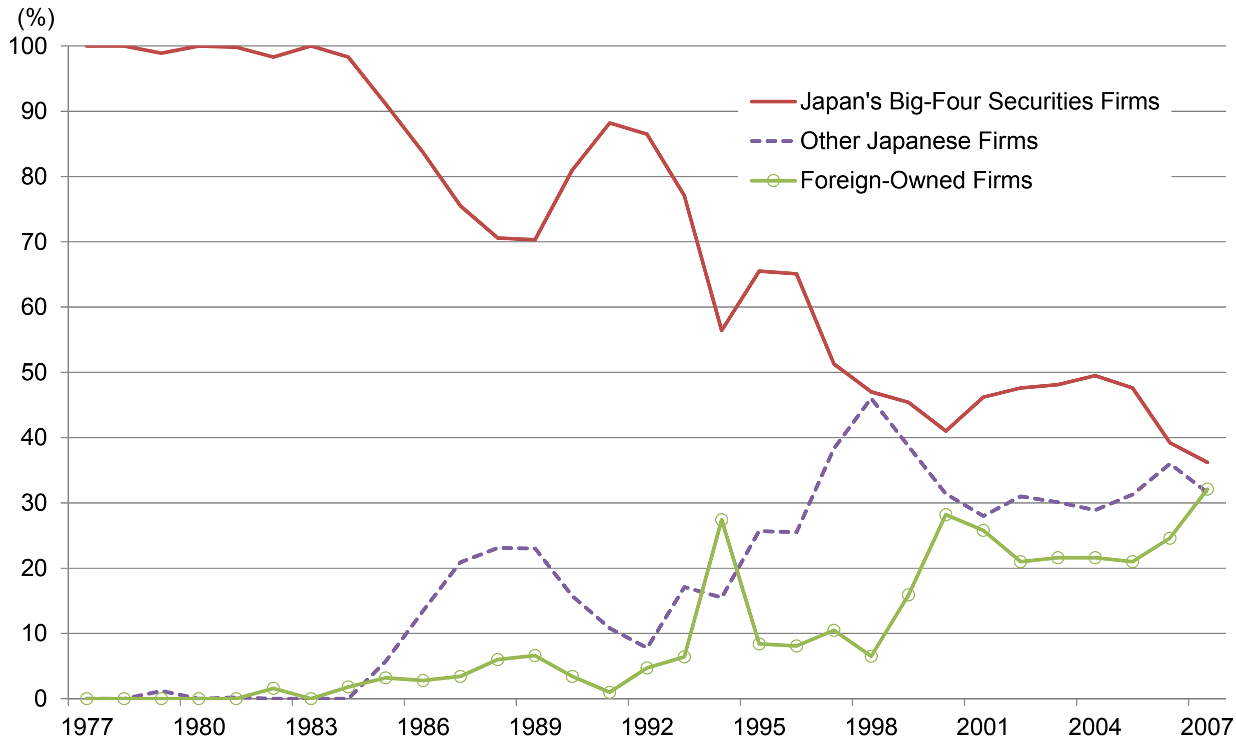
Looking at the relationship between the underwriting share of foreign-owned firms and underwriting commissions on yen-denominated bonds after 1985, we see that underwriting commission rates did in fact decline as the underwriting share of foreign firms grew.

Underwriting commissions on yen-denominated bonds began to decline after 1985 as the underwriting share of foreign-owned firms grew. Commissions were at 1.9% in 1985 and fell to 1.6% as of 1989 and 0.4% as of 1995. As for underwriting commissions on the domestic bond market, the level began to decline after 1990, lagging just a bit behind the Euroyen bond market. According to the Economic Planning Agency’s Annual Economic Report, the total of underwriting commissions on corporate bond issues, trustee fees, and other commissions averaged 1.8% as of March 1991, but then began to decline rapidly, reaching around 0.7% as of September 1992 and less than 0.6% after September 1994. The influence of the hollowing-out of the domestic market on deregulation is cited as one of the causes, but the opening up of lead manager business to foreign-owned firms in the Euroyen bond market and the competition for business which ensued because of that development is also thought to have contributed to the decline in commission fees charged by domestic firms.

The first foreign-owned firm to obtain the position of co-manager was the Tokyo branch of the U.S. firm Smith Barney on a yen-denominated foreign bond issued by Dow Chemical in January 1982. Then in October 1995, Merrill Lynch became the first foreign-owned firm to act as lead manager on a yen-denominated foreign bond issued by Merrill Lynch and Co. Inc.

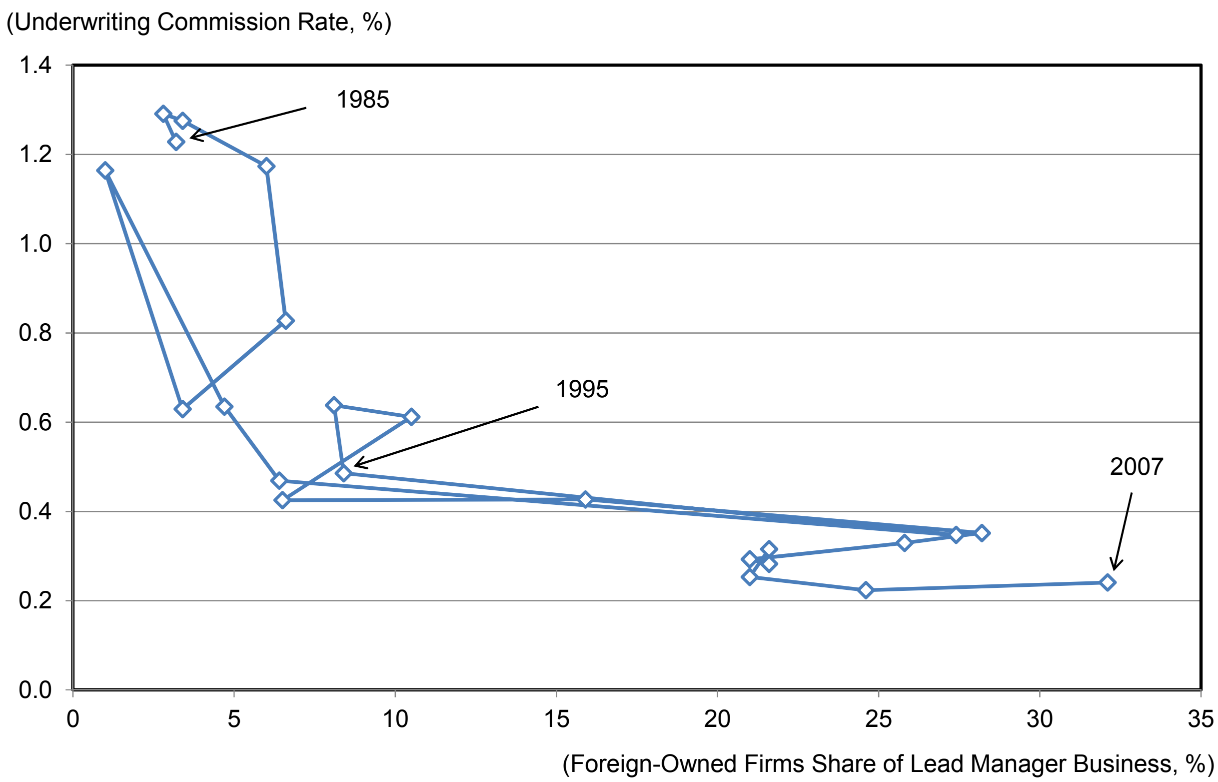
[45] Credit Suisse First Boston was the lead manager on the December 20, 1984 issue of a non-resident Euroyen bond for PG&E (Pacific Gas & Electric). The Union Bank of Switzerland acted as lead manager on the May 20, 1987 issue of a resident Euroyen bond for Chubu Electric Power.

Share of Lead Manager Business on Yen-Denominated Bonds — Chart 18



Source: Thomson Reuters; compiled by DIR.

Foreign-Owned Firms Share of Lead Manager Business in Yen Bond Market and Underwriting Commissions — Chart 19



Source: Ministry of Finance, International Finance Bureau Annual Report; compiled by DIR.
Note: Yen-denominated bond issues including domestic bonds, Euroyen bonds, and yen-denominated foreign bonds.

6.2 The Derivatives Market

6.2.1 Development of the Futures and Options Markets

Futures trade was not recognized under the American Occupation Forces Three Principles of Securities Trade.[46] [47] However, during the 1980s as liberalization and internationalization of Japan's capital market progressed, price fluctuation risk of stocks and bonds as well as other securities increased, and both domestic and overseas institutional investors were looking for a way to hedge their risk.

First bond futures, which at that time had become a big issue in the secondary market, were considered, and futures trade in this area became allowable under the June 1985 revision of the Securities and Exchange Act. Bond futures trade on the Tokyo Stock Exchange began in October the same year focusing on long-term government bonds.

Meanwhile, as the scale of Japan's stock market expanded, investors also required a means of hedging their risk in stock investments. Under the stipulations of the Securities and Exchange Act as they existed at that time, the way to do this was to establish the Futures 50 market on the Osaka Stock Exchange in June 1987 where stock futures were traded as a package of fifty spot-trading stock issues. Actual transfer of securities took place upon final statement. Another revision of the Securities and Exchange Act would be required in May 1988 in order to realize a full-fledged futures market with its own stock price index. Security index futures trade and securities options trading were newly established under the revised law. As a result of this development, TOPIX futures trade began on the Tokyo Stock Exchange in September 1988, while stock price index futures trade (the Nikkei 225 index) began at the same time on the Osaka Stock Exchange.

In April 1989 trading in bonds with options commenced (over-the-counter bond options), and in June of the same year, Nikkei 225 options trading began on the Osaka Stock Exchange. Options trading centering on TOPIX commenced on the Tokyo Stock Exchange later that year in October.

As for financial futures and options such as interest and currency, a new law separate from the Securities and Exchange Act was passed in May 1988 for this purpose. This was the Financial Futures Trade Law, under which the Tokyo International Financial Futures Exchange was established in April 1989 (currently called the Tokyo Financial Exchange). Trade commenced in June of the same year with activity centering on Japanese yen short-term interest rate futures, US dollar short-term interest rate futures, and yen-dollar currency futures. As an extension of the rule of separation of banks and securities companies, futures and options trade was also given a setup whereby the financial and securities fields would be separated for supervision and operation. Besides trade taking place at the stock exchange, the latter 1980s also saw the removal of the ban on overseas futures trade on the part of domestic financial institutions (as of May 1987) and deregulation of trade in Euroyen futures by foreign banks (December 1989).

6.2.2 Active Utilization of Futures Trade by Foreign Investors

The desire for a way to hedge risk was held equally by both domestic and overseas institutional investors, but it was in fact foreign investors who put futures trade to use effectively.

After stock price index futures trade commenced in 1988, the share of trading volume by foreign investors began to grow, not only for futures but for spot transactions as well. In 1984 foreign

[46] *Japan's Financial System Reform*, by Yoshimasa Nishimura (Toyo Keizai Shinposha, 2003), Pg. 197.
[47] The remaining two Principles of Securities Trade are “trade must take place at the stock exchange” and “time priority shall prevail.”

investors had a share of trading volume on the spot market of over 10%,[48] but soon after this figure declined, reaching 7% in 1988. Share of trade volume rose again after stock price index futures trade was introduced. By 2014, foreign investors had a share of trading volume on the spot market of nearly 60%.

Foreign investors’ share of trade volume in stock index futures was at around 1% when trade commenced in 1988,[49] but grew to over 10% by 1992 and continued its growth trend until reaching over 70% in 2014.

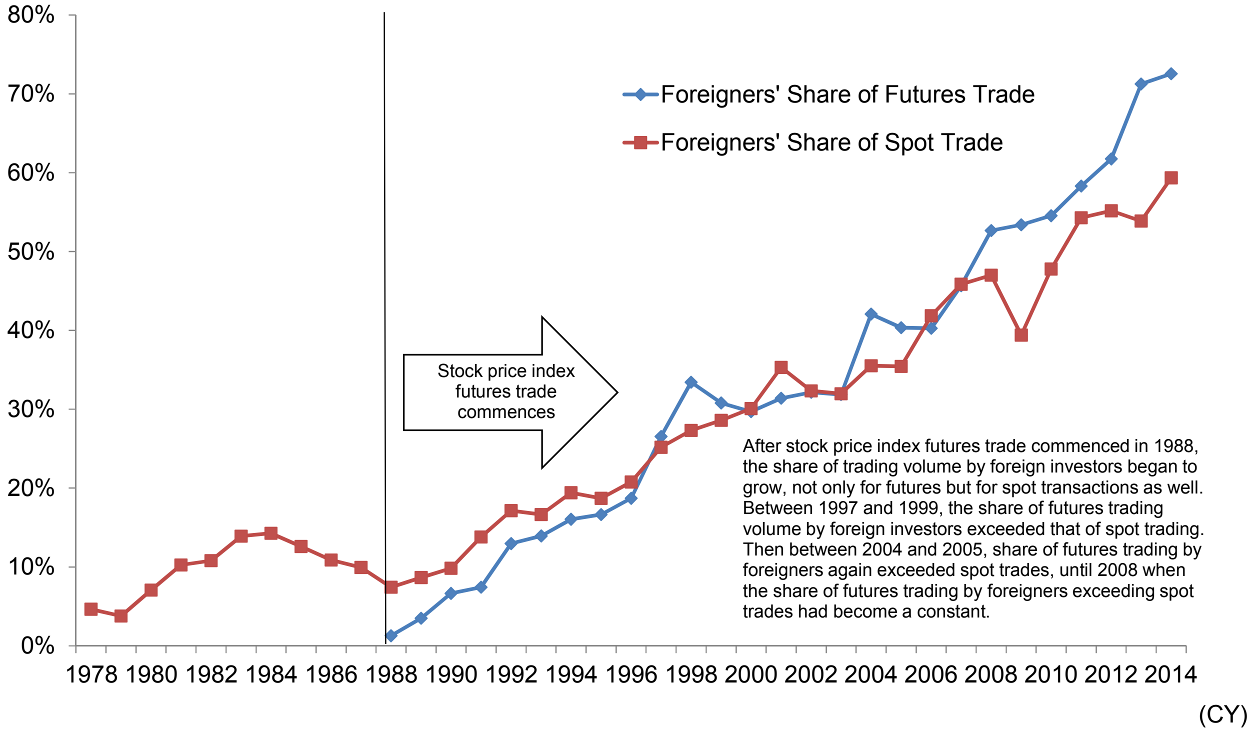
Foreign investors’ share of trade volume in stock index futures totaled 20 trillion yen in 1989, one year after the market was first established. Later, trade volume peaked in 1991 and 1999 with highs and lows occurring in between these peak periods. There was an overall growth trend until 2007. After the *Lehman Shock* which triggered the global financial crisis in 2008, trading volume fell drastically to about half of what its total had been in 2007 when it was at 690 trillion yen. Trading volume recovered some years later until exceeding the level of the year 2007 in 2013.

The share of trade volume in bond futures held by foreign investors also experienced a growth trend, registering hefty percentage figures since the commencement of trade in 1985 and moving into yet an even more heated growth trend in the 1990s and exceeding 40% in 2006. After this point foreigner investors’ share of trading volume began to mark time, but has entered another growth trend in recent years, exceeding 50% in 2014.

Trading activity on the part of foreign investors effectively utilizing derivatives even when stock prices are at a low has worked effectively for Japan’s market providing underlying support for trade volume. On the other hand, there has also been criticism, claiming that market volatility has increased due to the aggressive utilization of derivatives.

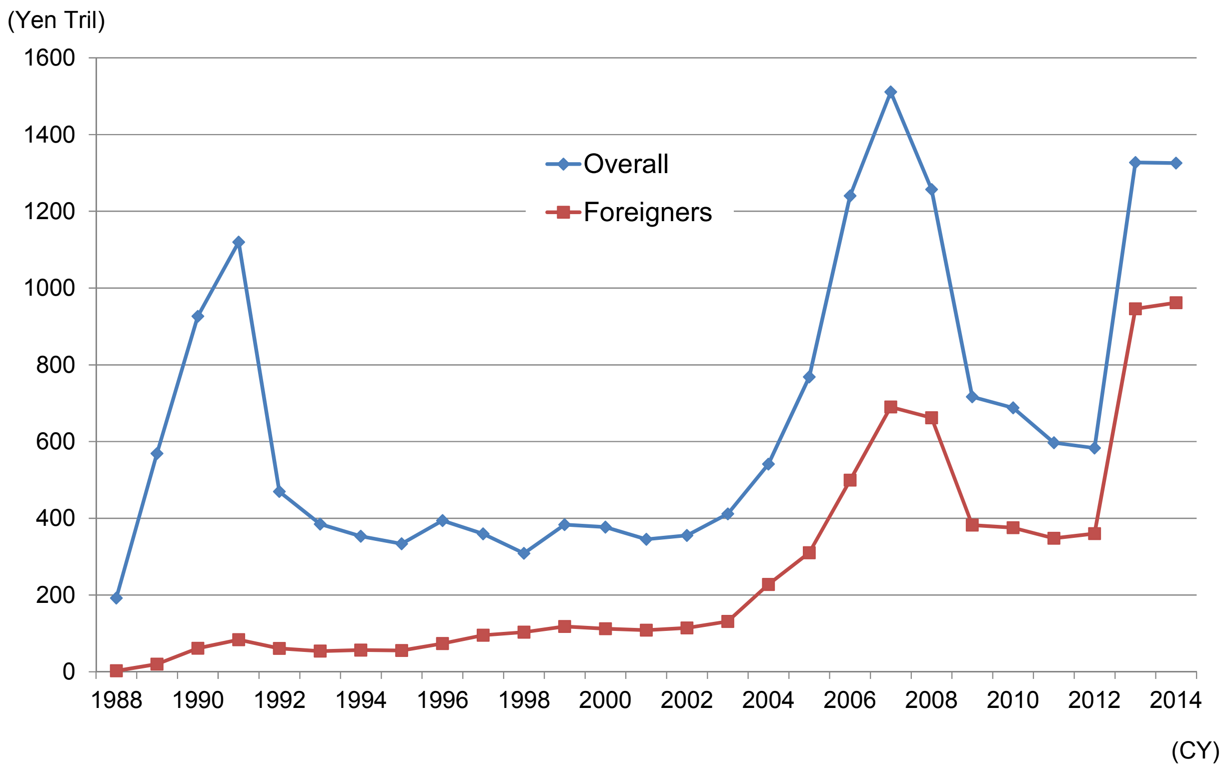
[48] Share of trading volume is calculated using trading volume in spot shares from each investment sector on both the First Section of the Tokyo Stock Exchange and the First Section of the Osaka Stock Exchange.
[49] Share of trading volume is calculated using a simple total of trading volume by investor in TOPIX futures, Nikkei 225 futures, and Nikkei 300 futures.

Foreign Investors' Share of Trading Volume in the Stock Market — Chart 20



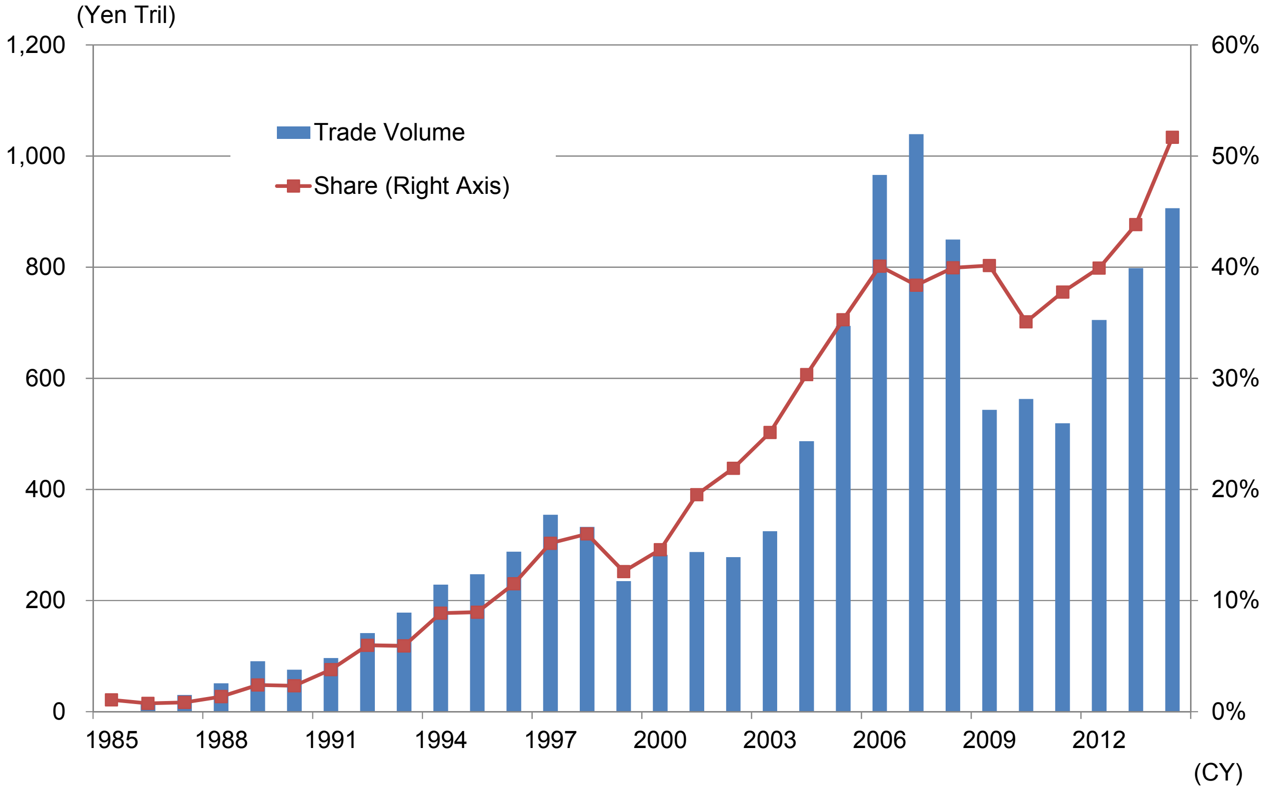
Source: Tokyo Stock Exchange, Osaka Stock Exchange, Japan Exchange Group; compiled by DIR.
Note: Share of trading volume is calculated using trading volume in spot shares from each investment sector on both the First Section of the Tokyo Stock Exchange and the First Section of the Osaka Stock Exchange and in the case of futures, a simple total of trading volume by investor in TOPIX futures, Nikkei 225 futures, and Nikkei 300 futures.

Trends in Trading Volume in Stock Price index Futures — Chart 21



Source: Tokyo Stock Exchange, Osaka Stock Exchange, Japan Exchange Group; compiled by DIR.
Note: Share of trading volume is calculated using a simple total of trading volume by investor in TOPIX futures, Nikkei 225 futures, and Nikkei 300 futures.

Foreign Investors' Share of Trading Volume in Bond Futures **Chart 22**



Source: Tokyo Stock Exchange; compiled by DIR.

6.2.3 Challenges in Pressing Forward toward Further Development

In introducing derivatives to one's own market, one might assume that domestic financial institutions should be given plenty of time to gradually adapt to the new market, but while domestic companies are taking their time trade would become completely focused on overseas markets. Moreover, growing and developing a new derivatives market also requires building a low cost, flexible system which is capable of handling the introduction of new products in an agile manner. A new regulatory regime must be established as well, covering issues such as diversification of settlement currencies and standardization of transaction procedures for each type of derivative product. Flexible trade practices are also required, meaning that training is needed for personnel. It will be essential for concerned individuals involved with the new system to change their way of thinking.

Compared to its spot market, Japan's derivatives market has been slow in gaining an international reputation due to a variety of issues including differences of opinion between government agencies and industries, and the length of time it takes for new products to be introduced, as well as issues surrounding cost. The question of whether or not the actual security which the derivative is based on is performing well also has influence on whether the derivative becomes established in the market. It seems that markets located near regions which are important in producing various commodities such as crude oil, soy beans, and other products, have the most strength.

More than half of derivatives trade in Japan is concentrated in the Nikkei 225, TOPIX, and long-term government bonds. The Nikkei 300, ultra-long-term government bonds, and midterm government bond futures markets have also been established, and at one time were attracting trading activity, but as time passed after their initial introduction trading has become sparse. There was some experimentation with futures linked to overseas stock indices or particular industries, but these too failed to become well-established.

The Chicago Mercantile Exchange **(**CME**)** is an international derivatives market flexible enough to introduce new products on a trial and error basis. The market has increased the number of products it offers for investment in this way. This is an important factor in establishing a flexible derivatives market. At the same time, however, it is also important to carefully determine whether or not there is latent demand for a derivative in one's own market based on the amount of trade taking place in the actual security which the derivative is linked to.

According to the 2014 FIA Annual Global Futures and Options Volume report, world futures and options trade in 2014 totaled 21.87 billion transactions. The breakdown in terms of instruments traded was as follows: individual stocks 29.7%, stock price index futures 26.7%, interest 14.9%, currencies futures 9.7%, agricultural products 6.4%, non-precious metals 4.0%, and precious metals 1.7%. As for ranking in terms of volume, the CME market was number one with total trade volume of 344.28 million transactions. The derivatives markets in Japan performed as follows: the Japan Exchange Group ranked number 15 with total trade volume of 309.73 million transactions, while the Tokyo Financial Exchange ranked number 32 at 40.9 million, the Tokyo Commodities Market ranked number 37 with 21.86 million transactions, and the Osaka Dojima Commodity Exchange ranked number 52 with a total of 310,000 transactions.

According to its publication entitled *Changes in Trade Volume of Derivatives on a Monthly and Annual Basis since Establishment*, The Japan Exchange Group recorded total trade volume in securities based derivatives in 2014 of 309.73 million. The breakdown by product was Nikkei 225 mini 64.3%, Nikkei 225 options trade 14.2%, Nikkei 225 futures 8.4%, TOPIX futures 6.7%, and long-term government bond futures 2.8%. The breakdown in trade volume does not reflect size in terms of monetary value, but it becomes immediately evident that the majority of trade is taking place on the Nikkei 225, TOPIX, and the long-term government bond futures market.

According to the *Commodities Exchange Volume Report* published by the Japan Commodity Clearing House, total trade volume on the Tokyo Commodities Exchange and the Osaka Dojima Commodity Exchange (total trade in all commodities in 2014) was 22.17 million transactions, or total amount of transactions of approximately 66 trillion yen. A simple comparison is not possible, but the scale of activity associated with derivatives linked to stocks and bonds seems fairly small. According to the *Annual Statistics* published by the Tokyo Financial Exchange, which features currency and interest futures, total trade volume of all products in 2014 was 40.90 million transactions.

6.3 The Yen-Denominated Bankers Acceptance (BA) Market

Included in the US-Japan Yen-Dollar Committee's 1984 report was a proposal suggesting that a yen-denominated BA market (trade related bankers acceptance) should be established in Japan. Separately from that proposal, the government's 1983 comprehensive economic measures stated the following goals: "promote the internationalization of the yen, implement further levels of liberalization in Japan's financial and capital markets, and more completely bring out the yen's latent strength." The government document then goes on to suggest that "the establishment of a yen-denominated bankers acceptance market should be considered in the mid to long-term."[50]

In response to the government's policy measures, the yen-denominated BA market was inaugurated in June 1985. Securities companies were authorized to handle distribution (retailing) of yen-denominated BA as a means of bringing more depth to the market and to encourage its development. This decision lagged ten months behind the market's commencement and was implemented in April 1986. The reason for the delay was worries that since securities companies were involved in trading in the existing commercial paper market there might be a regulatory issue. At first, only financial institutions and short-term money market brokers were allowed to handle BA. However, when the market got

[50] The Ministry of Finance, *Ministry of Finance Securities Bureau Annual, 1984 Issue* (Pgs. 48-49)

started in June of 1985, the scale of the market was already at 59 billion yen, and administrative work was becoming extremely complicated. For this reason market scale was decreased, and a year and a half later (from the end of 1986 to the beginning of 1987), the market fell to 20 billion yen and the issue died a natural death.[51]

While a short-term financing market already existed in Japan, including general domestic short-term loans, impact loans with swaps, CDs, and repurchase agreements, there was not a noticeable difference in interest between yen-denominated BA and other short-term financing under the current monetary easing environment. Moreover, paperwork was too much trouble on yen-denominated BA because of the requirement that a request had to be made to the Bank of Japan for storage when compiling original bills. In the case of third-country trade there was a rigid requirement that the original transaction must be carried out in yen and the paying bank must be a Japanese bank. These issues were a hindrance to expansion of trading in yen-denominated BA.

Although a yen-denominated BA market was established during the mid-1980s, it was pretty much dead because of difficulty of use and the existence of alternatives. But with the Asian currency crisis of 1997 and the further internationalization of the yen, it was argued in or around 2000 that the market should be revived.

The Ministry of Finance Council on Customs, Tariff, Foreign Exchange and other Transactions had the following to say in its report entitled "Internationalization of the Yen Looking Forward to the 21st Century – Changes in the World Economy and Financial Situation and Japan's Response (April 20, 1999)": "From the viewpoint of Asian export and import firms raising yen capital, the opinion has been expressed that reviving the yen-denominated BA market would provide financial support for yen-denominated trade in the Asian region." Meanwhile, in a proposal published by the Japan Federation of Economic Organizations on March 2, 2000 entitled "Toward Internationalization of the Yen – Internationalization of the Yen for Use as a Trade Settlement Currency," the following statement appears: "Yen-denominated BA can become a useful tool for Asian corporations in their carrying out of yen-denominated trade finance. We are of the opinion that measures to revive the market should be considered, including the application of Bank of Japan rediscounting for non-resident issues of yen-denominated BA." However, concrete steps were never actually taken to revive the yen-denominated BA market.

From the viewpoint of promoting the internationalization of the yen, reviving the yen-denominated BA market is considered to be an important factor, and it will likely become necessary to make changes so that it is easier to utilize. However, since there are alternatives available to those seeking an appropriate instrument for short-term finance, one has to keep in mind the needs of users, and this is where doubts arise – the reason that the yen-denominated BA market died a natural death is because there were no compelling reasons, no urgent need, for such a market. Assuming the government wants to promote a policy of establishing a yen trading zone, attempts to revive the yen-denominated BA market can take on significance only where doing so produces a desirable situation for Japanese corporations as well as those of other countries. Perhaps the government should also have come up with a clear argument as to the extent to which it wanted the yen to be internationalized.

[51] Market scale figures are from *Tokyo's International Financial Market*, Editor in Chief Ichiro Tachiryu, Editors Masao Noh, O Okamasa, and Junko Maru (Yuhikaku, 1988), Pg. 78

6.4 The Tokyo Offshore Market

Liberalization and internationalization of Japan’s financial and capital markets was encouraged by the US-Japan Yen-Dollar Committee’s 1984 report and the 1985 Foreign Exchange Council report regarding internationalization of the yen. This culminated in the establishment of the Tokyo Offshore Market in 1986. At the time, non-residents tended to make much less use of the short-term investment market in the form of deposits, CDs and repurchase agreements as compared to the long-term investment market, such as stocks and bonds. The establishment of the Tokyo Offshore Market was a response to this imbalance.

The Tokyo Offshore Market provided special international financial transactions accounts (offshore accounts) authorized by the Minister of Finance. These accounts could be used for carrying out transactions where the other party was a non-resident, and made it possible to use capital procured overseas for investments carried out overseas. In other words, these accounts were specifically for the purpose of carrying out offshore transactions. This market was cut-off and insulated from the domestic market, and therefore not subject to regulations regarding interest, deposit insurance, or reserve deposits. Interest on accounts was also tax free (free from both income tax withholding and payment of corporate tax).

The scale (asset balance) of the Tokyo Offshore Market was 15 trillion 518.1 billion yen as of end December 1986, soon after its inauguration. Later it would steadily expand due to the increase in interest rate arbitrage and intensive activity in capital transactions on the world’s offshore markets, until end December 1997 when it reached 97 trillion 151.6 billion yen. Securities transactions were allowed on the Tokyo offshore market as of April 1998, but then the asset balance decreased as a result of the Asian currency crisis and bankruptcies amongst major financial institutions. By the mid-2000s the asset balance had declined to less than 40 trillion yen. The market’s asset balance began to grow again in mid-2012, and as of end January 2015 had reached 93 trillion 561 billion yen.

7. Conclusion: What Japan's Experience Suggests

This report has covered the major topics in Japan's experience of opening its capital markets to foreign participation. Not all of this experience is necessarily applicable to today's emerging economies. Today, globalization is progressing rapidly and has touched every corner of the world, hence the environment that emerging economies find themselves in is quite different than when Japan began to liberalize. This is especially so in the area of trade, with pretty much all nations but for a few exceptions well integrated in the global economy. There are many cases where the area of capital transactions has already reached an advanced stage of liberalization. However, there are also many cases where these kinds of transactions are carried out under the direction of one of the advanced nations or with the help of a corporation from one of these nations. In some cases a country can find itself in a situation where financial instability can be triggered quite easily. In order for the emerging nations to achieve stable economic growth, it is necessary to promote the expansion and development of the capital markets in their own countries.

The liberalization of capital is considered to have been a necessary measure to strengthen the competitiveness of Japan's corporations and capital markets by virtue of promoting competition. In the case of Japan, the major motivating force in opening its markets was pressure from overseas. However, being that this provided the basis for the globalization of its capital markets, it also provided benefits for domestic corporations. But despite the liberalization of the legal framework, there were still cases where foreign-owned companies were unable to enter Japan's market. The existence of regulations and customary practices which remained opaque are often pointed out as being the reason. Japan has a history of reviewing and readjusting regulations and customary practices in the form of responding to specific, concrete demands regarding specific areas (some would say forced to by US and European interests), and one typical example is the opening up of membership in the Tokyo Stock Exchange. Continuous and progressive review of regulations and customary practices is important in increasing the number of foreign-owned firms entering the market.

In carrying out the liberalization of capital in Japan, there was the highly advanced capital protection systems of cross-shareholding ties between former zaibatsu-type industrial groups. Along with the Japanese style main bank system, this type of business conglomerate is often considered to have been important as a means of maintaining management stability when Japan was still at the stage of economic development. However, once Japan's economy had matured, it became more important to attain a level of transparency in corporate governance so that globalization could progress, making it necessary to change this Japanese style structure. In modern times, countries advancing toward the liberalization of capital are expected by the international community to have a high level of transparency in corporate governance. In order to avoid overly rapid change, a process in which appropriately changing regulations associated with foreign-owned capital is carried out in stages should be considered.

The entry of foreign-owned securities companies can lead to more efficient price formation on the market through the stimulation of arbitrage trades, program trading, and trading of derivatives. Moreover, more diverse investors, such as hedge funds, will be encouraged to become participants. However, in Japan, along with the increase in the ratio of foreign-owned companies came an increase in linkage with the US stock market, and entry of foreign-owned companies into the market has meant the possibility that market volatility could also increase. This is another factor which one must be on guard against. Meanwhile, the entry of foreign-owned underwriters and investment banks with selling power leads to smoother capital procurement on overseas markets, as well as activating more M&A deals in both the domestic market and overseas.

Once liberalization and opening up takes place, competition will heat up and a shakeout could occur amongst domestic securities companies. Competitiveness of the securities industry overall will likely be strengthened, but caution is also required so that domestic investors do not become unprofitable in the shakeout process.

Development of a bond issuance market is also important as liberalization and the opening up of the market progresses. It is considered to be desirable to develop a healthy international bond issuance market which is easy to use by overseas participants. This includes the cultivation of an offshore market and a foreign bond market with bonds denominated in one’s own country’s currency.

With active underwriting taking place by foreign-owned companies on an international bond issuance market, there is a possibility that commission rates could decline due to the promotion of competition. This benefits the issuing firm in that it becomes easier to procure funds. However, in Japan, liberalization of brokerage commissions was progressing at the same time as the bond issuance market. This meant that domestic securities companies which depended on brokerage commissions were forced to quickly change their business models. These changes require supervision and guidance so as to avoid instability in the securities industry overall.