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## The Regulation of Domestic and Foreign Financial Institutions in Japan

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# COMMERCIAL LAW AND INVESTMENT

## ARTICLES

### THE REGULATION OF DOMESTIC AND FOREIGN FINANCIAL INSTITUTIONS IN JAPAN

Dean C. Alexander†

#### INTRODUCTION

This paper provides an overview of both domestic and foreign financial institutions operating in Japan. Also, it discusses the obstacles of foreign financial institutions attempting to provide services in the Japanese market. Part I describes the banking regulatory guidelines of national treatment and reciprocity. Part II explains the types of financial institutions in Japan and their functions. Part III describes the Japanese financial scandal that was recently exposed and its implications. Part IV provides an overview of foreign financial institutions operating in Japan. Part V critiques the complaints brought by foreign financial institutions regarding their treatment in Japan. Part VI describes Japan's response to these complaints. Part VII lists the significant developments in financial deregulation affecting banking institutions in Japan. Part VIII discusses the U.S. legislative responses to Japanese barriers confronting foreign financial insti-

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tutions. Part IX concludes that the Japanese have made significant progress in their treatment of foreign financial institutions, but further liberalization would assist both Japanese and non-domestic banks in Japan.

# I. BANKING REGULATORY GUIDELINES OF NATIONAL TREATMENT AND RECIPROCITY

Nations regulate foreign financial institutions under either a national treatment or reciprocity model.<sup>1</sup> Under a national treatment model, a foreign banking institution is treated the same as a domestic banking institution whereby the legal burdens and benefits are the same.<sup>2</sup> In other words, the activities that a foreign bank carries out in the host country are the same as those that a domestic bank performs.<sup>3</sup> Sometimes treatment of a foreign banking institution, termed national treatment plus, occurs.<sup>4</sup> Under this framework, a foreign financial institution is treated better than the domestic financial institution.<sup>5</sup>

Under a reciprocity model, a host nation authorizes the establishment of a foreign financial institution solely on the condition that the applicant's home country similarly authorizes the establishment of the host country's institutions in the applicant's domestic market.<sup>6</sup> Generally, host countries that favor reciprocity require that the applicant's home country permit some form of foreign entry, but not necessarily one that is identical to the one offered by the applicant's country.<sup>7</sup>

Difficulty exists in implementing a reciprocity model since

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<sup>1</sup> Organization For Economic Cooperation and Development, *International Trade in Services: Banking* 9, 13 (1984) [hereinafter OECD]; Brian W. Semkow, *The American Trade Deficit With Japan: Whither The Role of Japanese Financial Reregulation of Liberalization*, MD. J. INT'L L. & TRADE 39, 54-57 (1988). See generally R.M. PECCHIOLI, *THE INTERNATIONALIZATION OF BANKING* (1984); RICHARD DALE, *THE REGULATION OF INTERNATIONAL BANKING* (1984); Michael J. Feinman, *National Treatment Of Foreign Banks Operating in the United States: The International Banking Act of 1978*, 11 LAW & POL'Y INT'L BUS. (1979).

<sup>2</sup> Semkow, *supra* note 1, at 55.

<sup>3</sup> *Id.*

<sup>4</sup> *Id.*

<sup>5</sup> OECD, *supra* note 1, at 13.

<sup>6</sup> *Id.*

<sup>7</sup> *Id.* See generally JONATHAN D. ARONSON & PETER F. COWHEY, *TRADE IN SERVICES: A CASE FOR OPEN MARKETS* 35-39 (1984).

the home country regulatory frameworks of prospective banks from different nations are varied. As a result, the host country faces the possibility of permitting the same type of financial institution from different countries to carry out diverse financial activities. Yet, if greater harmonization - and ultimately uniformity - of home country financial laws were to exist, the implementation of reciprocity models would be much easier.

In a May 1984 Report on Yen/Dollar Exchange Rate Issues,<sup>8</sup> Japan and the United States agreed that Japan should accord foreign financial institutions national treatment.<sup>9</sup> Similarly, the parties indicated the need for greater transparency in the manner Japanese capital market regulations and laws are carried out. Increased transparency would enable greater access to non-Japanese firms.<sup>10</sup> Japan planned to implement the national treatment model in the following ways: by permitting foreign financial firms to participate in the activities that Japanese trust banks carry out; by permitting foreign financial firms to participate in government securities markets; and by assisting foreign firms to join the Tokyo Stock Exchange (TSE).<sup>11</sup>

Yet, in its discussion, Japan did not give an absolute guarantee to follow the national treatment framework. Rather, Japan could choose to administer domestic and foreign financial institutions using the reciprocity model. In doing so, "foreign financial institutions in Japan would be accorded the same treatment as Japanese financial institutions in the foreign country with respect to regulation and supervision as well as business powers."<sup>12</sup> As will be demonstrated in this paper, Japan's treatment of foreign financial institutions can be categorized as using either a national treatment or a reciprocity regime, depending on the area of regulation.

The openness or restrictiveness of a banking system - in a

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<sup>8</sup> JAPANESE MINISTRY OF FIN., U.S. DEPT. OF TREAS., REPORT ON YEN/DOLLAR EXCHANGE RATE ISSUES, at § V(B)(1)-(3) (1984) [hereinafter EXCHANGE RATE ISSUES]; see JEFFERY A. FRANKEL, INSTITUTE FOR INT'L ECONOMICS, POLICY ANALYSIS IN INT'L ECONOMICS No. 9, THE YEN/DOLLAR AGREEMENT: LIBERALIZING JAPANESE CAPITAL MARKETS 3 (1984).

<sup>9</sup> *Id.*

<sup>10</sup> EXCHANGE RATE ISSUES, *supra* note 8, at § V(B)(3).

<sup>11</sup> *Id.* at §§ V(B)(1)-(2), V(A)(4); Semkow, *supra* note 1, at 54.

<sup>12</sup> Semkow, *supra* note 1, at 55.

host or home country - will influence a prospective bank's preference for either the national treatment or reciprocity models.<sup>13</sup> For example, a financial institution whose home country has a liberalized regulatory scheme would prefer a reciprocity model when it operates in a country with a more stringent legal framework.<sup>14</sup> In contrast, a financial institution whose home country has a stringent regulatory framework would prefer a national treatment model when it operates in a country with a more liberalized framework.<sup>15</sup> Consequently, the conflict between the use by a host country of either reciprocity or national treatment models results in inconsistent and contradictory approaches when dealing with foreign financial institutions.<sup>16</sup>

Due to the Japanese restrictions on financial services in general, and on foreign institutions in particular, foreign financial institutions generally prefer to be regulated under the framework of reciprocity.<sup>17</sup> For example, German banks, which enjoy great freedoms in their country, prefer the reciprocity approach.<sup>18</sup> Since a strict reciprocity standard is not possible in Japan, national treatment is preferable to a standard of less than national treatment. Also, transparency in the regulation of foreign financial institutions is necessary "toward[s] entry into and operations in the Japanese capital market[s],"<sup>19</sup> so that non-domestic financial institutions would have "equal effective opportunity."<sup>20</sup>

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<sup>13</sup> *Id.* See *Japan's National Study on Trade in Services*, JAPAN ECON. J., Oct. 1984, at 55. "The concept of regulatory arbitrage embraces the notion that securities firms will migrate from one jurisdiction to another to avoid markets subject to relatively more stringent rules governing disclosure, manipulative conduct, and other regulations protective of investors." Manning G. Warren III, *Global Harmonization of Securities Laws: The Achievements of the European Communities*, 31 HARV. INT'L L.J. 185, 189 (1990).

<sup>14</sup> Semkow, *supra* note 1, at 55.

<sup>15</sup> *Id.*

<sup>16</sup> *Id.* at 55-56. See OECD, *supra* note 1.

<sup>17</sup> EXCHANGE RATE ISSUES, *supra* note 8, at § V(B) introduction; see generally Semkow, *supra* note 1, at 54-55.

<sup>18</sup> Semkow, *supra* note 1, at 56.

<sup>19</sup> EXCHANGE RATE ISSUES, *supra* note 8, at § V(B) introduction; Semkow, *supra* note 1, at 54.

<sup>20</sup> Semkow, *supra* note 1, at 54.

## II. FINANCIAL INSTITUTIONS IN JAPAN

The Ministry of Finance (MOF) plays a key role in regulating a host of issues in the arena of Japanese finance.<sup>21</sup> The MOF consists of seven bureaus and a Secretariat.<sup>22</sup> Of the various bureaus, three are paramount:<sup>23</sup> the Banking Bureau,<sup>24</sup> the Securities Bureau,<sup>25</sup> and the International Finance Bureau.<sup>26</sup>

For many years, Japanese financial institutions were at the zenith of international finance.<sup>27</sup> In fact, in 1990, the following description was provided:

Japanese banks, ranked by asset size, occupy seven out of the top ten places in global ratings; the world's top ten banks ranked by market share are all Japanese, with some \$2 trillion of interna-

<sup>21</sup> David Lake, *Bankers as Brokers*, Bus. Tokyo, Sept. 1991, at 46, 47.

<sup>22</sup> *Id.* at 47.

<sup>23</sup> *Id.*

<sup>24</sup> *Id.* The Banking Bureau consists of three parts: "[t]he coordination division fixes reserve rates, oversees interest-rate adjustments and regulates funds available to financial institutions. The commercial-bank division licenses and supervises banks in cooperation with the inspection division. The insurance division licenses all aspects of the insurance industry." *Id.*

<sup>25</sup> The Securities Bureau's "major divisions include coordination, capital management, corporate finance, secondary-market trading and inspection. Corporate disclosures and the investment-advisory business are subject to its supervision. Securities regulation is also enforced by the bureau and its branch offices." *Id.* Unfortunately, the Securities Bureau is woefully understaffed. Kaori Shoji, *MOF In The Hot Seat*, Bus. Tokyo, Sept. 1991, at 4. After all, while the U.S. Securities and Exchange Commission staff numbers 2,400, the MOF's Securities Bureau includes only thirty-five. *Id.*

<sup>26</sup> The International Finance Bureau's "short-term capital markets division supervises Japanese financial institutions and manages foreign-exchange reserves. The foreign-investment division watches portfolio investment, the floatation of securities, the Euroyen bond market and other capital-market activities." David Lake, *supra* note 21, at 47.

<sup>27</sup> Tony Shale, *Capital and Costs Curb Global Ambitions*, EUROMONEY, Sept. 1990, at 113 [hereinafter Shale, *Global Ambitions*]; Clay Chandler, *Japanese Banks Are Surviving Bubble's Burst*, WALL ST. J., Nov. 25, 1991, at A8 [hereinafter Chandler, *Bubble's Burst*]. But see Sterngold, *Good Times for Japan's Banks?*, N.Y. TIMES, May 13, 1991, at F13. Yet:

1990 was a miserable year for Japan's financial sector, as interest rates soared, stocks plummeted and bank profits evaporated. But it was a great year for the financial press, which spun out dire warnings that Japan's overextended financial institutions were teetering dangerously and might take the Western World down with them.

*Id.* Nevertheless, the future of the city banks appear rather bright. In fact, Robert Zelinski, a senior analyst at Jardine Fleming Securities in Tokyo suggests that city banks' profits would increase fifteenfold between now and 1994. *Id.*

tional business on their books; Japanese banks account for over 38% of all such lending; Tokyo has the world's largest stock market and is expected to surpass London as the financial centre where most foreign exchange is traded; and Japanese banks are leading their international competitors in credit ratings and hidden assets.<sup>28</sup>

Yet, as will be discussed later, 1991-92 brought unfavorable news to both the profitability and prestige of Japanese financial institutions.

The banking industry in Japan consists of government and commercial banks.<sup>29</sup> The government banks in Japan include the Bank of Japan and the Export and Import Bank of Japan.<sup>30</sup> The Bank of Japan, the central bank, issues bank notes and coins and carries out the traditional functions of a central bank.<sup>31</sup> The Export and Import Bank of Japan provides, *inter alia*, financing for foreign purchasers of Japanese products.<sup>32</sup>

Generally, Japanese commercial banks are separated into four groups: ordinary banks, long-term credit banks, trust banks, and foreign exchange banks.<sup>33</sup> First, the ordinary banks include twelve city banks and an additional sixty-four regional banks.<sup>34</sup> Among the strongest of the city banks are Fuji, Mitsubishi, Dai-ichi Kangyo, and Sumitomo.<sup>35</sup> Second, long-term credit banks

<sup>28</sup> Shale, *Global Ambitions*, *supra* note 27, at 113.

<sup>29</sup> See Frances Rosenbluth, *The Political Economy of Financial Reform in Japan: the Banking Act of 1982*, 6 UCLA PAC. BASIN J. 62 (1989) [hereinafter Rosenbluth, *Political Economy*]; FRANCES ROSENBLUTH, FINANCIAL POLITICS IN CONTEMPORARY JAPAN (1989) [hereinafter ROSENBLUTH, CONTEMPORARY]; JAPANESE BANKING, SECURITIES, AND ANTI-MONOPOLY LAW 17 (Hiroshi Oda and R. Geoffrey Grice eds., 1988).

<sup>30</sup> Oda, *supra* note 29, at 17.

<sup>31</sup> *Id.* See generally YOSHI SUZUKI, MONEY AND BANKING IN CONTEMPORARY JAPAN: THE THEORETICAL SETTING AND ITS APPLICATION 5-13 (1980); ROBERT A. FELDMAN, JAPANESE FINANCIAL MARKETS: DEFICITS, DILEMMAS AND DEREGULATION 42-52 (1986).

<sup>32</sup> Terutomo Ozawa, *Japan's Largest Financier of Multilateralism: The EXIM Bank*, 20 J. WORLD TRADE L. 599, 602 (1986). See Oda, *supra* note 29, at 17; ROSENBLUTH, CONTEMPORARY, *supra* note 29; Rosenbluth, *Political Economy*, *supra* note 27; Dean C. Alexander, *The Export-Import Bank of the United States Battle Against Subsidized Export Credits*, 9 DICK. J. INT'L L. 267 (1991).

<sup>33</sup> See Oda, *supra* note 29, at 17; ROSENBLUTH, CONTEMPORARY, *supra* note 29; Feldman, *supra* note 31.

<sup>34</sup> Oda, *supra* note 29, at 18. But see Gerhard Hinterhauser, *Down Tumble the Barriers*, BANKER, Jan. 1987, at 65-66 (listing thirteen city banks) [hereinafter Hinterhauser].

<sup>35</sup> Rosenbluth, *Political Economy*, *supra* note 29, at 65. See Chandler, *Bubble's*

were created by the Law of Long-Term Credit Bank, which aims to provide long-term finance in Japan.<sup>36</sup> The long-term credit banks include the Industrial Bank of Japan Ltd., the Long-Term Credit Bank of Japan Ltd., and the Nippon Credit Bank Ltd.<sup>37</sup> Noteworthy is that the long-term credit banks are able "to issue debentures of five to seven years maturity in exchange for long-term lending to industry."<sup>38</sup> Third, trust banks essentially make lengthy loans to corporations, issue long-term debentures, and receive extensive monies from pension funds and trust accounts.<sup>39</sup> Fourth, the Bank of Tokyo, the only foreign exchange bank, was established in 1954 by the Law of Foreign Exchange Bank.<sup>40</sup> The Bank of Tokyo was created with the intent to assist foreign trade as well as to enter foreign currency transactions.<sup>41</sup> Other, small-scale financial institutions include regional banks, mutual banks, small credit associations, agricultural cooperatives, and small credit cooperatives.<sup>42</sup>

The Japanese financial industry has undergone changes during the latter half of the 1980's. For instance, loan demand has lessened since many companies have resolved to raising more funds on international capital markets.<sup>43</sup> Also, banks' funding costs have risen due to interest rate deregulation.<sup>44</sup> Furthermore, the strict distinctiveness between financial institutions' authorized roles have evolved due to financial liberalization.<sup>45</sup> Part of the ramifications of such changes are that the city

*Burst*, *supra* note 27, at A8.

<sup>36</sup> Oda, *supra* note 29, at 18; see Chandler, *Bubble's Burst*, *supra* note 27, at A8.

<sup>37</sup> Oda, *supra* note 29, at 18.

<sup>38</sup> Rosenbluth, *Political Economy*, *supra* note 29, at 65.

<sup>39</sup> *Id.* Among the trust banks are Mitsubishi, Sumitomo, and Mitsui. Hinterhauser, *supra* note 34, at 66.

<sup>40</sup> Oda, *supra* note 29, at 18.

<sup>41</sup> *Id.*

<sup>42</sup> Rosenbluth, *Political Economy*, *supra* note 29, at 65. The key regional banks include the Bank of Yokahana, Hokuriku, and Chiba. Hinterhauser, *supra* note 34, at 66. Among Japan's lending institutions, there are the following number in each grouping: National and regional banks (237); Zenshinren bank (1); Shinkin banks (454); National Federation of Credit Coop's (1); Credit Coop's (414); National Federation of Labour Credit Association (1); Labour Credit Association (47); Shokochukin bank (1); Norinchukin Bank (1); Agricultural Coop's (3668); and Fishery Coop's (1750). Anthony Rowley, *Japan's S & L Crisis?*, *FAR E. ECON. REV.*, Jan. 24, 1991, at 36.

<sup>43</sup> Hinterhauser, *supra* note 34, at 65.

<sup>44</sup> *Id.*

<sup>45</sup> *Id.*



banks have played a greater role in financing small- and medium-sized Japanese corporations.<sup>46</sup> Whereas previously small- and medium-sized Japanese banks played a key role in funding the aforementioned clients, city banks' share of such lending rose to 50%.<sup>47</sup> As a result, smaller banks were forced to allocate greater funding to securities investments, particularly investment trusts or tokkin funds.<sup>48</sup> Also, the city banks, despite Ministry of Finance rules preventing them from raising funds with maturities greater than two years, have expanded into the arena of the long-term credit banks and trust banks, namely long-term financing.<sup>49</sup>

The fiscal year ending March 31, 1990 did not bring cheerful news to several key sectors of Japan's financial community.<sup>50</sup> More specifically, Japan's city banks' pre-tax profits declined by 11.6%; seven trust banks' pre-tax profits fell by 17.2%; and the three long-term credit banks' pre-tax profits were reduced by 14.4%.<sup>51</sup> Particularly disheartening reports continued for Japan's city banks in the year ending March 31, 1991; in that year pre-tax profits dropped 19.7%.<sup>52</sup>

The strength of some Japanese banks appears to have declined steadily in recent times. More specifically, the value of the Industrial Bank of Japan's shares have decreased in value some 24% in one week - April 1 to April 8, 1992.<sup>53</sup> During the same period dramatic losses have also been witnessed at Dai-ichi Kangyo Bank Ltd. (22%); Fuji Bank Ltd. (28%); Mitsubishi Bank (18%); and Sanwa Bank Ltd. (23%).<sup>54</sup> The dramatic drop of the value of these bank stocks is due in large measure to the dramatic decline in the Tokyo Stock Exchange, in which these

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<sup>46</sup> *Id.*

<sup>47</sup> *Id.*

<sup>48</sup> *Id.*

<sup>49</sup> *Id.*

<sup>50</sup> Amitabha Chowdhury, *Japan: Bank Profits and Capital Ratios Take Hard Knocks*, ASIAN FIN., Aug. 15, 1990, at 36-40.

<sup>51</sup> *Id.*

<sup>52</sup> David Lake, *Japan: Banks Reel From Profit Crash*, ASIAN FIN., Aug. 15, 1991, at 35-36.

<sup>53</sup> Paul Blustein, *Japan Stocks Continue Their Slide*, WASH. POST, Apr. 8, 1992, at C1, C2.

<sup>54</sup> *Id.*

banks have heavily invested.<sup>55</sup> Further difficulties may occur since the need for Japanese banks to raise funds to meet the Bank of International Settlement standards may prove costly and arduous.<sup>56</sup> As a result, Japanese banks will be forced to reduce lending, and thereby increase the cost of funds.<sup>57</sup>

More specifically, Japanese banks had to meet the Bank for International Settlements 8% minimum capital requirements call by March 31, 1992.<sup>58</sup> As a result, they raised capital by issuing high-cost subordinated debt.<sup>59</sup> Yet, as loan growth rises slowly to 1-2%, many Japanese companies that purchased bank shares in order to obtain favorable loans from such banks may no longer pursue such actions.<sup>60</sup> For instance, Daishowa Paper recently sold 1.68 million shares of the Industrial Bank of Japan.<sup>61</sup> Similarly, Dai-Ichi Mutual Life Insurance began to decrease the amount of various bank stocks, including the Bank of Tokyo, that it held.<sup>62</sup>

Other dilemmas face Japanese commercial banks. More specifically, the city banks made numerous real estate loans - totaling approximately \$11 trillion - and must negotiate with troubled developers, whose property values have decreased some 20-40%.<sup>63</sup> Additional estimates surmise that at least \$110 billion in troubled domestic loans threaten Japanese banks. Ample proof of such hazards is Sumitomo Trust's assisting an insolvent finance company, Nippon Mortgage.<sup>64</sup> Furthermore, Japanese banks have approximately \$50 billion in bad overseas loans as well as some \$15 billion in uncollectible sovereign loans to Eastern Europe and the former Soviet Union.<sup>65</sup>

Also, since Japanese banks must follow 8% capital ade-

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<sup>55</sup> *Id.* at C2.

<sup>56</sup> *Id.*

<sup>57</sup> *Id.*

<sup>58</sup> Dyan Machan, Peter Fuhrman, and Andrew Tanzer, *Finance Shokku*, FORBES, Apr. 13, 1992, at 42-43.

<sup>59</sup> *Id.* at 42.

<sup>60</sup> *Id.*

<sup>61</sup> *Id.*

<sup>62</sup> *Id.*

<sup>63</sup> *Id.*

<sup>64</sup> *Id.* at 43.

<sup>65</sup> *Id.*

quacy ratios,<sup>66</sup> as set out by the Bank for International Settlements (BIS), a major movement towards asset-backed securitization, totaling about \$100 billion, will occur.<sup>67</sup> The BIS guideline has forced banks to weigh the possibility of securitization of their own assets.<sup>68</sup> At the same time, since traditional funding from banks may become limited, corporate clients will look increasingly to both private placements and Euroyen bond markets.<sup>69</sup> Yet, significant barriers (e.g., legal, tax, and social) remain prior to the expansion of an asset-backed market in Japan.<sup>70</sup> Nevertheless, some banks have begun this asset-backed securitization with a vengeance. For example, in August 1990, Citibank, using trade receivables of Kawasaki Steel, launched a \$500 million commercial program in the United States. Citibank's deal, which implemented "for the first time Japanese receivables . . . assigned to a special-purpose vehicle," was accepted by many investors.<sup>71</sup>

The Ministry of Finance's Fundamental Research Committee of the Securities and Exchange Council has acknowledged that the legal impediments to full securitization in Japan is "the unavoidable wave of the future."<sup>72</sup> Similarly, the Ministry's Financial System Research Council declared that obstacles to securitization must be eliminated.<sup>73</sup> The Ministry of Finance's receptive attitude towards securitization was exhibited in October 1990 when it granted licenses to eleven firms (nine foreign, two domestic) to trade in credit-backed securities.<sup>74</sup> Previously, the Ministry of Finance prohibited securities firms from dealing

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<sup>66</sup> *Security in Big Numbers*, EUROMONEY, Mar. 1991, at 37-41 [hereinafter *Security in Big Numbers*].

<sup>67</sup> *Id.* at 37-38; Kenneth H. Bacon, *Multinational Banks Are Likely To Face Stricter Oversight In U.S. And Europe*, WALL ST. J., Aug. 23, 1991, at A2.

<sup>68</sup> *Security in Big Numbers*, *supra* note 66, at 37-38. "Eurocurrencies are deposits in a bank located outside the territory in which the currency is the national currency." Dean C. Alexander, *The Legal and Economic Impact of the Federal Reserve Board's Ruling To Allow U.S. Depository Institutions To Accept Foreign Currency Deposits*, 14 N.C. J. INT'L L. & COM. REG. 459, 462 (1989) [hereinafter Alexander, *Deposits*]. See generally EXCHANGE RATE ISSUES, *supra* note 8, at 25-30.

<sup>69</sup> *Security in Big Numbers*, *supra* note 66, at 37.

<sup>70</sup> *Id.* at 38.

<sup>71</sup> *Id.*

<sup>72</sup> *Id.* at 40.

<sup>73</sup> *Id.*

<sup>74</sup> *Id.*

in asset-backed securities because they were not considered securities.<sup>75</sup>

The securities industry is largely dominated by four securities houses — Nikko, Yamaichi, Daiwa, and Nomura. The “Big Four” are the largest traders and retailers of securities and make up about three-quarters of all bond and stock issues.<sup>76</sup>

The Tokyo Stock Exchange (TSE) has undergone a number of changes over the years. For instance, activity on the TSE fluctuated from an average of 428 million shares traded daily in 1985 to 1,035 in 1988, and subsequently declined to 500 million in 1990.<sup>77</sup> Various forms of deregulation were exhibited at the

<sup>75</sup> *Id.* See Yoshiki Shimada, *A Comparison of Securities Regulation in Japan and the United States*, 29 COLUM. J. TRANSNAT'L L. 319 (1991).

<sup>76</sup> Rosenbluth, *Political Economy*, *supra* note 29, at 66.

Among the reasons for success by the Big Four are several-fold. First, after World War II, Japan's securities industry was fairly undeveloped. Consequently, the Ministry of Finance adopted policies that would protect Japanese securities firms. By the latter half of the 1950s, the Ministry of Finance had chosen the Big Four as securities firms that it would give priority (such as permitting the Big Four preference in opening branches). Second, the fixed commission systems for brokering, underwriting, and investment trust fees enabled the Big Four to secure its position without worrying about competition regarding the aforementioned fees. Third, the Big Four benefitted from their influence in obtaining Ministry of Finance approval for new products. Fourth, the Big Four played a key role in assisting the Ministry of Finance to gather information about the stock market. Shigeki Kakinuma, *Omnipotent Big Four*, TOKYO BUS. TODAY, December 1988, at 12-17.

<sup>77</sup> Todd Harris, *The Deregulation Dance*, BUS. TOKYO, June 1991, at 48, 49.

During the second half of the 1980s, the Tokyo market's dizzying rise enabled Japanese companies to raise 85 trillion yen - about \$620 billion at current exchange rates - on extraordinarily favorable terms. They were often able to borrow at interest rates in the 1 percent to 2 percent range by issuing bonds with the option of converting them into stock - an attractive lure as long as Tokyo's market seemed headed out of sight.

The virtually free capital helped spur a Japanese corporate splurge on plants and equipment and research and development that, by its sheer size, left American industry in the dust.

Despite an economy that is about three-fifths the size of the United States', Japan's capital spending totaled about \$660 billion in 1990, nearly 25 percent more than the amount spent by U.S. firms.

But now, interest rates in Japan and the United States are much closer than before and the U.S. stock market is hovering at near-record heights. Result: The Japanese funding advantage has all but disappeared, many analysts contend.

Paul Blustein, *Tokyo Market Facing Eclipse*, WASH. POST, Sept. 1 1991, at H1 [hereinafter, Blustein, *Eclipse*]. See Quentin Hardy, *Nikkei Resumes Its Course, Losing 3.44%*, WALL ST. J., Apr. 14, 1992, at C1, C12.

TSE. For instance, in 1985, a TSE futures bond market arose.<sup>78</sup> In 1988, stock index trading, termed the Nikkei 225,<sup>79</sup> took form.<sup>80</sup> Moreover, the TSE has been a leader in integrating international stock and futures trading.<sup>81</sup>

During the first half of 1990, reduced profits among the Big Four were staggering: Nikko was down 74.2%; Nomura was down 55.1%; Yamaichi was down 74.2%; and Daiwa was down 59.6%.<sup>82</sup> In addition, four of the second-tier Japanese securities firms experienced profit decreases by over 70%.<sup>83</sup> There were several reasons for these losses.<sup>84</sup> First, equity brokerage commissions, which constitute the Big Four's largest source of profits, declined significantly.<sup>85</sup> Second, the temporary suspension on securities firms to underwrite public offerings of convertible and warrant bonds and stocks eliminated a previously profitable sector.<sup>86</sup> This temporary suspension, which was aimed at eliminating new securities from entering an overextended market, caused a two-thirds decline in underwriting commission charges for

<sup>78</sup> Harris, *supra* note 77, at 48-49.

<sup>79</sup> Alexander, *Deposits*, *supra* note 68, at 465; Machan, *supra* note 58.

<sup>80</sup> Harris, *supra* note 77, at 48-49.

<sup>81</sup> *Id.*; Alexander, *Deposits*, *supra* note 68, at 465-66. See TAKEJI YAMASHITA, JAPAN'S SECURITIES MARKETS A PRACTITIONER'S GUIDE (1989); Norman Sklarewitz, *How To List On The Tokyo Stock Exchange: Why List? For Fame And A Good Staff*, EUROMONEY, Jan. 1988, at 5-7; Hidetoshi Miyamoto, *The Role of Securities In Japan's Financial Market*, BUS. JAPAN, Jan. 1987, at 49, 51.

<sup>82</sup> Tony Shale, *The Big Four Take A Beating*, EUROMONEY, Feb. 1991, at 38-41 [hereinafter Shale, *The Big Four*]. See James Sterngold, *A Financial Giant's Slippery Slope*, N.Y. TIMES, Mar. 10, 1991, at F1, F6 [hereinafter Sterngold, *Giant*].

[E]ven for a formidable global colossus like Nomura — it has a staggering \$14.7 billion in equity behind it, four-and-a-half times as much as Merrill Lynch & Company, America's largest brokerage house — these are trying times. The firm's profits are expected to plunge up to 60% in the fiscal year ending March 31 [1991], from \$2.1 billion the previous year [1990].

*Id.* See also James C. Hyatt, *Debts of Japanese Securities Firms Are Downgraded*, WALL ST. J., Feb. 10, 1992, at C11.

<sup>83</sup> Shale, *The Big Four*, *supra* note 82, at 40.

<sup>84</sup> *Id.*

<sup>85</sup> *Id.* See also Sterngold, *Giant*, *supra* note 82, at F6 (graph, "Commissions on the sale of securities as a percentage of worldwide fiscal revenue" was 41% for Nomura, 16% for Shearson, and 15% for Merrill Lynch.) "Bowling to foreign pressure, trading costs have been gradually reduced. The TSE cut brokerage commission rates 9.1% in 1986 and an additional 7% in June 1990. But unlike New York and London, it has stopped short of deregulating fixed commissions — cash cows for the Big Four brokerage houses . . . ." Harris, *supra* note 77, at 48.

<sup>86</sup> Shale, *The Big Four*, *supra* note 82, at 40.

Nikko, Daiwa, and Yamaichi.<sup>87</sup> Third, significant declines in the lead-managing of Eurobonds among the Big Four were witnessed in 1990. As a result, these four institutions, which had 38% of the head positions in a Eurobond syndication in 1989, held only 20% in 1990.<sup>88</sup> Fourth, the Big Four have witnessed significant declines in their investment trust sales.<sup>89</sup> Investment trust sales, which account for approximately 10% of operating income, will continue to fall, since investors still fear a repeat of the huge losses they suffered in the October 1987 crash.<sup>90</sup>

In 1991, it was determined that the Ministry of Finance would permit the Industrial Bank of Japan, Long-Term Credit Bank, and Nippon Credit Bank (all long-term credit banks) to carry out securities underwriting, in addition to other securities-related activities.<sup>91</sup> Other institutions that would be permitted to delve into the securities industry include the twelve city banks.

On April 8, 1992, the Tokyo Stock Exchange's Nikkei 225 Stock Index lost 3.5% to 17,791.55, marking its lowest level since November 27, 1986.<sup>92</sup> The weakness in the Tokyo Stock Exchange is further evidenced by the more than 50% decrease in its value since the end of 1989.<sup>93</sup> In addition, volume on the Exchange, which in 1989 sometimes reached 3 billion shares a day, reached 300 million shares only once in 1992.<sup>94</sup> This apparent gloom among investors has been demonstrated by Nomura Research Institute's recent recommendation for customers to "sell"

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<sup>87</sup> *Id.*

<sup>88</sup> *Id.* Nomura Securities

retained its No. 1 ranking last year for underwritings in the Euromarket, the fourth straight year it has held the top spot. But its market share was slashed almost in half, to less than 9 percent. In Tokyo, it was late in taking up the newest imported fad, computerized program trading, and thus finds itself a distant fourth in the lucrative activity — behind three American securities houses.

Sterngold, *Giant*, *supra* note 81, at F1.

<sup>89</sup> Shale, *The Big Four*, *supra* note 82, at 41.

<sup>90</sup> *Id.* at 40.

<sup>91</sup> *Id.* at 41.

<sup>92</sup> James Sterngold, *Stock Fall In Japan Worsens*, N.Y. TIMES, April 8, 1992, at D1 [hereinafter Sterngold, *Stock Fall Worsens*].

<sup>93</sup> *Id.*

<sup>94</sup> Quentin Hardy, *Nomura Analysts Break Tradition By Giving Investors The Bad News*, WALL ST. J., Feb. 26, 1992, at C1, C6.

several Japanese stocks.<sup>95</sup> Such recommendations are particularly unusual in that generally Japanese securities firms have suggested clients to either "buy" or "hold".<sup>96</sup>

Consequently, the Japanese Government has taken steps to spur the economy and the Exchange. More specifically, the Government has accelerated public spending, and the Bank of Japan has cut interest rates.<sup>97</sup> Also, in order to decrease the instability and weakness in the Exchange, the Ministry of Finance allegedly requested large Japanese stockholders, including insurance companies, to refrain from lending shares to various short-term sellers.<sup>98</sup> The Ministry of Finance is concerned that these short-term sellers, who sell the borrowed stock and subsequently hope to repurchase it as its price falls, are encouraging losses in insurance companies' stock holdings.<sup>99</sup>

In another vein, the cornerstone of the debate on the possible changes to Japan's financial markets is found in Article 65 of the Securities and Exchange Law.<sup>100</sup> That Article provides that trust companies, life insurance companies, and banks may not enter the securities business as brokers, dealers, or underwriters.<sup>101</sup> Japanese securities firms oppose the modification of Article 65, but would support some adjustments that would enable them to enter into the foreign exchange business.<sup>102</sup> Also, given recent scandals that have hit Japanese securities firms, they appear to lack the capital and desire to challenge the major city banks in the general banking business area.<sup>103</sup>

During the Spring of 1991, two advisory reports on potential liberalization in Japan's financial sector were presented to the Ministry of Finance for review.<sup>104</sup> In May 1991, the Securities and Exchange Council issued a report (Royama Report) in

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<sup>95</sup> *Id.* at C16.

<sup>96</sup> Steingold, *Stock Fall Worsens*, *supra* note 92, at D1.

<sup>97</sup> Quentin Hardy, *Nikkei Resumes Its Course, Losing 3.4%*, WALL ST. J., April 14, 1992, at C1, C12.

<sup>98</sup> *Id.* at C12.

<sup>99</sup> *Id.*

<sup>100</sup> Tetsuya Morimoto & William J. Seiter, *Japan's Financial System Reform: Stalled on the Tracks*, INT'L FIN. L. REV., Sept. 1991, at 30.

<sup>101</sup> *Id.*

<sup>102</sup> *Id.*

<sup>103</sup> *Id.*

<sup>104</sup> *Id.*

which it warned that entry by Japanese banks into the securities business must be carried out slowly.<sup>105</sup> The Royama Report, in comments paralleling those of the Japan Securities Dealers Association, emphasized that the purposes underlying Article 65's opposition to bank interference in the securities business — "(i) maintaining the financial health of the banking system; (ii) preventing conflicts of interest between the bank's role as lender [and] its role as underwriter or equityholder; and (iii) circumventing market domination of the securities sector by the largest banks through their immense economic power over corporate clients" — are key principles that must be upheld.<sup>106</sup> Consequently, the Royama Report suggests that while parent bank participation in the private placement business should continue, banks should not carry out other securities business at the parent company level.<sup>107</sup> Yet, the Royama Report recommends allowing banks to conduct some underwriting business by subsidiaries holding licenses to engage in the securities business.<sup>108</sup> In doing so, banks will face greater competition, particularly from the Big Four. Yet, because in the past Japanese commercial banks had much influence over their customers, the Royama Report suggests that scrutiny of the securities subsidiaries of such banks for their clients' securities issuances is necessary.<sup>109</sup>

Next, the Royama Report addresses the issue of stock-brokering. The Report determines that neither parent banks nor their newly-established securities subsidiaries should be permitted to act as brokers.<sup>110</sup> The rationale for this discussion is twofold: the small securities firms' reliance on brokering as their key source of income and the extensive corporate holdings of Japanese commercial banks.<sup>111</sup> The Royama Report also addresses the role of securitization of products (e.g., mortgage-backed and receivables-backed securities, commercial paper).<sup>112</sup> In addition, the Royama Report opines that to change the narrow definition

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<sup>105</sup> *Id.*

<sup>106</sup> *Id.* at 31.

<sup>107</sup> *Id.*

<sup>108</sup> *Id.*

<sup>109</sup> *Id.*

<sup>110</sup> *Id.*

<sup>111</sup> *Id.*

<sup>112</sup> *Id.*



of "securities" in Japan's Securities and Exchange Law must change to a non-exhaustive definition that would include various financial products as well as corporate stocks and bonds.<sup>113</sup> Yet, commercial banks fear such a change may limit their capacity to carry out transactions in securitization-related instruments at the parent level without encroaching Article 65 of the Securities and Exchange Law.<sup>114</sup>

In June 1991, the Financial System Research Council's System Problems Specialist Committee issued a report (FSRC Report) describing potential structural changes to Japan's financial institutions.<sup>115</sup> The basic tenets of the FSRC Report included: "relaxing the existing bar on cross-entry among the securities, banking and trust banking fields, . . . [and allowing for] optional conversion of Japan's specialized long-term credit banks . . . foreign exchange banks . . . [and] regular banks."<sup>116</sup>

Regarding the form of entry, the FSRC Report suggests that commercial banks, trust banks, and securities companies reciprocally could enter each others businesses by using three types of subsidiary companies: "securities subsidiaries licensed under SEL [Securities and Exchange Law]; banking subsidiaries licensed under the Banking Law; and trust banking subsidiaries licensed under the Banking Law; and holding trust business approval under the Law Concerning Concurrent Trust Business by Regular Banks."<sup>117</sup> As a result of these proposed changes, Japanese commercial banks would be able to work in the securities business by utilizing a subsidiary corporation.<sup>118</sup> Another key point of the FSRC Report is that distinct capital and net asset requirements would depend on the securities business carried out by subsidiaries.<sup>119</sup>

There are other structural approaches to the integration of securities firms, commercial banks, and trust banks.<sup>120</sup> First, under the *sogo noriire* (mutual convergence) approach, these

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<sup>113</sup> *Id.*

<sup>114</sup> *Id.*

<sup>115</sup> *Id.*

<sup>116</sup> *Id.*

<sup>117</sup> *Id.*

<sup>118</sup> *Id.*

<sup>119</sup> *Id.*

<sup>120</sup> *Id.* at 32.

banks would be permitted to engage in each other's businesses at the parent company level.<sup>121</sup> Second, under the universal banking scenario, financial institutions would be empowered to participate as commercial banks, investment banks, and trust banks.<sup>122</sup> As such, it follows the European model of a single financial institution with multi-level powers.<sup>123</sup> Although the Ministry of Finance has generally opposed the universal banking concept, its attributes — simplicity in its application — are useful.<sup>124</sup> Third, a special-law investment bank proposal would create a new type of investment bank which would be limited to wholesale financial transactions, and would be authorized to carry out various activities from long-term and short-term finance to trust and securities business.<sup>125</sup> Fourth, a financial services holding company approach would have limited securities business activities through non-banking affiliates.<sup>126</sup>

Upon reviewing the FSRC Report and the Royama Report, it appears that ultimately some changes to Article 65 of the Securities and Exchange Act will occur. Recent scandals<sup>127</sup> in the Japanese securities business strengthens the pressure by the banking industry to reform Article 65.

Lastly, the Japanese postal system, administered by the Ministry of Posts and Telecommunications (MPT), contains a savings system with a deposit base larger than any in the world: 100 trillion yen.<sup>128</sup> The postal system provides higher interest rates and more beneficial terms than non-banks.<sup>129</sup> In 1986, the share of the personal savings market by form in Japan was as follows: the postal savings system held 30.9%; city banks 17.9%; mutual banks 6.9%; credit associations 11.6%; agricultural cooperatives 12.3%; and others 6.1%.<sup>130</sup>

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<sup>121</sup> *Id.*

<sup>122</sup> *Id.*

<sup>123</sup> *Id.*

<sup>124</sup> *Id.*

<sup>125</sup> *Id.*

<sup>126</sup> *Id.*

<sup>127</sup> See *infra* Part III.

<sup>128</sup> ROSENBLUTH, CONTEMPORARY, *supra* note 29, at 167-68.

<sup>129</sup> *Id.*

<sup>130</sup> *Id.* at 181.

### III. FINANCIAL SCANDAL IN JAPAN

Recent revelations regarding questionable and illegal practices in the Japanese financial community merit close attention.<sup>131</sup> The major financial scandals that have been prevalent in the United States in recent years similarly have surfaced in Japan.<sup>132</sup> In April 1989, three banks, Dai-Ichi Kangyo, Fuji, and Mitsui, were ordered by Japan's National Tax Administration to pay 1.58 billion yen for their inaccurate announcement of off-shore subsidiaries' profits.<sup>133</sup> Also, in 1989, it was discovered that between 1975 and 1984 Daiwa Securities unlawfully gave over twenty corporate customers yield guarantees on ten billion yen of investments.<sup>134</sup>

The recognition of the extent of scandal in some areas of the Japanese financial industry grew in the 1990's. In particular, in October 1990, four employees at Mitsui Trust & Bank allegedly did not tell tax authorities that they had earned 1.8 billion yen in securities trading by using inside information.<sup>135</sup> During that same month, Atinori Yamashita, a former manager of the Aobadi branch of Sumitomo Bank, was charged with persuading the Bank's "clients to lend . . . 43.9 billion [yen] to groups speculating in stocks and illegally guaranteed the clients high short-term returns in the process."<sup>136</sup> If the allegations are proved, Mr.

<sup>131</sup> T.R. Reid, *Japan's Scandalous Summer of '91*, WASH. POST, Aug. 3, 1991, at A18.

<sup>132</sup> See Charles R. Babcock, *Helms Report Urges Censure Of Cranston in "Keating 5" Case*, WASH. POST, Aug. 5, 1991, at A4; Rudolph A. Pyatt, Jr., *BCCI Case Raises Questions About the Very Integrity of U.S. Banking Laws*, WASH. POST, Aug. 29, 1991, at B14; George Lardner, Jr., *CIA Probed, Used BCCI, Official Says*, WASH. POST, Aug. 3, 1991, at A1.

<sup>133</sup> Tony Shale, *Sumitomo's Dangerous Liaisons*, EUROMONEY, Dec. 1990, at 16-17 [hereinafter Shale, *Sumitomo*].

<sup>134</sup> *Id.* at 17. See James Sterngold, *Prominent Speculator Is Indicted in Japanese Stock Case*, N.Y. TIMES, Aug. 10, 1990, at D10.

<sup>135</sup> Shale, *Sumitomo*, *supra* note 75, at 17.

<sup>136</sup> *Id.* at 16. More specifically, Mr. Akinori Yamashita is accused of promising high returns on loans from three bank clients worth . . . 11.4 billion [yen] which he, in his personal capacity, funnelled to the Koshin speculator group, led by 53 year-old Mitsuhiro Kotani, between March and September 1988. He is also accused of repeating the process on two later occasions by channeling loans worth . . . 32.5 billion [yen] to the Seibi group, led by Akira Kato, between March and June 1990.

*Id.* at 16.

Yamashita violated the Law Concerning the Regulation of Receiving Capital Subscriptions, Deposits, and Interest on Deposits.<sup>137</sup> Generally, this legislation “prohibits employees of financial companies from engaging in loan transactions for third parties outside the jurisdiction of their firms.”<sup>138</sup> Yet, the sanctions for such appear to be rather mild — only a fine.<sup>139</sup>

Within days of the arrest of Mr. Yamashita, Sumitomo Bank Chairman Ichiro Isoda resigned from his post, noting: “It is extremely regrettable that such a crime has been committed by a former branch manager of a bank with great public obligations. It is natural for the head to take responsibility.”<sup>140</sup> Yet, numerous “well-placed observers in Tokyo” suggest that Mr. Isoda was pressured to resign “by a high-ranking politician or by the emissaries of the ruling bureaucracy at the Ministry of Finance.”<sup>141</sup>

During the summer of 1991, a number of other financial scandals were uncovered. On June 21, 1991, Nomura Securities International, Inc. and Nikko Securities Company admitted compensating its key clients more than \$100 million for losses made in the Tokyo Stock Exchange in 1990.<sup>142</sup> More specifically, Yasuhiro Mizuuchi, a Nomura vice president, explained that his company paid a number of institutional investors approximately \$114 million in compensation for securities trading losses.<sup>143</sup> Similarly, Masao Yuki, a Nikko vice president, stated that his

<sup>137</sup> *Id.* at 17.

<sup>138</sup> *Id.*

<sup>139</sup> *Id.*

<sup>140</sup> *Id.*

<sup>141</sup> *Id.* In particular, these well-placed observers suggest:

that the politician, ex-prime minister Yasuhiro Nakasone, intervened because he feared that his links in the past with Kotani [a securities speculator group] would drag his name into the affair. And they [observers] believe that MOF wanted to punish Sumitomo for being, in its eyes, a disobedient upstart whose over-aggressive strategy and practices had begun to rock the Japanese banking boat. If the MOF could also shift the blame for the negative social effects of stock and real-estate market speculation onto Sumitomo, then it would have achieved a double victory.

*Id.*

<sup>142</sup> Paul Blustein, *2 Major Japanese Securities Firms Concede Favoritism to Big Clients*, WASH. POST, June 22, 1991, at D1 [hereinafter Blustein, *Firms Concede Favoritism*].

<sup>143</sup> *Id.*

firm had compensated key investors more than \$120 million for securities trading losses.<sup>144</sup> Essentially, Nomura and Nikko purchased, at inflated prices, securities from their customers, who had lost money on these investments.<sup>145</sup> In Japan, this manner of compensation would have been illegal only if the securities firm previously had agreed to reimburse its customer for his losses.<sup>146</sup>

In addition, Japanese securities firms acknowledged that they engaged in business with the Japanese crime syndicate.<sup>147</sup> In particular, Nikko and Nomura acknowledged that they provided loans of approximately \$250 million to Susumu Ishii, a former leader of Inagawa-Kai, a part of the Japanese underworld.<sup>148</sup> However, these securities firms proffer that they were unaware of their ties to this Japanese group "until it was too late."<sup>149</sup> Sadly, this admission by Nomura and Nikko has demonstrated that the Japanese syndicate has diversified "their traditional rackets such as prostitution and extortion by getting into the stock and real estate markets."<sup>150</sup>

The shadow that was now setting on Nomura and Nikko caused the firms to take immediate action.<sup>151</sup> Soon, Yoshihisa Tabuchi, Nomura's president, resigned in order to take responsi-

<sup>144</sup> *Id.* at D4.

<sup>145</sup> *Id.*

<sup>146</sup> *Id.*

<sup>147</sup> *Id.*

<sup>148</sup> *Id.* at D1.

Ishii used the money [from the securities firms] to buy a substantial stake in Tokyu Corp., a real estate and railroad company, Nomura helped drive up Tokyu's shares, boosting the value of Ishii's investment by more than 50 percent at the end of 1989. Nomura acknowledged that it had actively trade[d] Tokyu shares, but said it had done so because it was recommending the company to clients. The Tokyo Stock Exchange has reportedly launched an investigation of the trading in Tokyu shares.

*Id.* Also, Nomura Securities Co. and Nikko Securities Co. allegedly "bought some \$29 million worth of golf memberships from Susumu Ishii . . . perhaps to compensate him for losses." Karen Lowry Miller, *Goodfellas, Japanese-Style: Well-Connected and 20% Legit*, *Bus. Wk.*, Aug. 26, 1991, at 44. See Yomiko Ono & Clay Chandler, *Mobster's Death Robs Authorities Of Key Witness In Japan Scandals*, *WALL ST. J.*, Sept. 6, 1991, at A5D.

<sup>149</sup> Paul Blustein, *Heads of 2 Japanese Securities Firms Quit*, *WASH. POST*, June 25, 1991, at C1 [hereinafter Blustein, *Heads of Securities Firms*].

<sup>150</sup> *Id.*

<sup>151</sup> *Id.*

bility "for damaging investors' confidence in the equity market."<sup>152</sup> Tabuchi explained, "[n]o securities firm should ever compensate any customer for stock losses."<sup>153</sup> Similarly, Takuya Iwasaki, president of Nikko, stepped down from his position in order to apologize "to the society and industry."<sup>154</sup>

In July 1991, the Japanese financial scandal was exposed even further. A leading Tokyo newspaper, *Nihon Keizai Shimbun*, released "the names of 228 corporations and pension funds including some of the country's most prestigious firms — that were secretly refunded about \$950 million in trading losses on their brokerage accounts."<sup>155</sup> Among the reimbursement beneficiaries were leading Japanese companies, including Nissan Motors Co., Matsushita Electric Industrial Co., and Hitachi Ltd.<sup>156</sup> These large companies are among brokerage firms' important clients,<sup>157</sup> and consequently the compensation was easy to surmise. At the same time, it was discovered that a number of smaller players received compensation, including small companies, savings banks, credit unions, and individuals.<sup>158</sup> Some suggest that this support of small Japanese companies by securities firms was due to Japanese government policy that brokers assist "small customers so they would not face bankruptcy."<sup>159</sup> Thus, there is speculation that the Japanese government's involvement in the scandal is wider than previously suggested.<sup>160</sup>

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<sup>152</sup> *Id.*

<sup>153</sup> Paul Blustein, *Japanese Scandal Widens*, WASH. POST, July 23, 1991, at D1 [hereinafter Blustein, *Japanese Scandal Widens*].

<sup>154</sup> Blustein, *Heads of Securities Firms*, *supra* note 149, at C1.

<sup>155</sup> T.R. Reid, *Japan Stock Scandal Beneficiaries Identified*, WASH. POST, July 30, 1991, at E1 [hereinafter Reid, *Japan Stock Scandal*].

<sup>156</sup> *Id.* "The big firms, known . . . as oh-guchi, or 'big-mouth' investors - Japan's equivalent of 'fat-cat' - are the kind of important customers that brokerage firms would clearly want to satisfy." *Id.* "Hitachi Ltd.'s stock market investments, for example, were all but insured by Nomura. As the scandals have now exposed, the broker forked out \$16 million to cover over the last couple of years." Robert Neff, *Hidden Japan The Scandals Start To Reveal How The System Really Works*, BUS. WK., Aug. 26, 1991, at 34.

<sup>157</sup> Reid, *Japanese Stock Scandal*, *supra* note 155, at E1.

<sup>158</sup> *Id.*

<sup>159</sup> *Id.*

<sup>160</sup> *Id.*

Bureaucrats play a confusing role as both coddlers and regulators of industry . . . . Indeed, the Japanese have refined back-room dealing to an art. One expression of this is the *zoku* - informal 'tribes' of Diet members from the ruling Liberal Democratic Party (LDP) who watch out for different interest groups and

The scandal involving compensating investors for securities trading losses widened to include eighteen second-tier Japanese securities firms.<sup>161</sup> More specifically, in August 1991, four second-tier Japanese securities firms admitted that they had compensated their clients for securities losses to a total of 874 million yen (\$6.4 million) over an eighteen-month period that ended in March 1990.<sup>162</sup> The four brokerage firms involved in this activity were Aizawa Securities Co., Izumi Securities Co., Meiko Securities Co., and Naigal Securities Co.<sup>163</sup> First, Aizawa Securities Co. acknowledged that it compensated "15 companies, including Fuji Bank Ltd. and Nippon Trust Bank, Ltd., and fifty-eight individuals a total of 128 million yen."<sup>164</sup> Second, Naigal Securities Co. distributed 481 million yen in compensation to Komatsu Ltd.'s Komatsu Finance Co. unit (receiving the highest amount); Nippon Credit Bank (35 million yen); Mitsubishi Corp. (19 million yen); and Hitachi Ltd. (10 million yen).<sup>165</sup> Third, Meiko Securities stated that it provided its European subsidiary and eight persons 104 million yen in compensation.<sup>166</sup> Fourth, Izumi Securities Co. "paid five companies, including two credit associations, a total of 161 million yen in compensation."<sup>167</sup>

On August 26, 1991, Japanese Finance Minister Ryutaro Hashimoto, speaking before a Japan parliamentary panel investigating the securities scandal, acknowledged that "his agency had known since 1983 that Japanese brokerage firms were compensating favored clients for stock trading losses, but merely advised them to avoid the practice."<sup>168</sup> An economist at the Mitsubishi Research Institute emphasized that the "MOF knew all

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intercede deftly when necessary.

Neff, *supra* note 156, at 35.

<sup>161</sup> Blustein, *Japanese Scandal Widens*, *supra* note 153, at D4.

<sup>162</sup> *Four More Japanese Brokerage Houses Identify Clients Compensated For Losses*, WALL ST. J., Aug. 19, 1991, at A5B.

<sup>163</sup> *Id.*

<sup>164</sup> *Id.* "Fuji bank, which Aizawa Securities listed as having received 30 million yen, said the compensation was made through a discretionary account controlled entirely by the brokerage house. . . . Nippon Trust Bank expressed surprise at being included on the list, which said the bank received six million yen." *Id.*

<sup>165</sup> *Id.*

<sup>166</sup> *Id.*

<sup>167</sup> *Id.*

<sup>168</sup> *Japan Disclosure In Scandal*, WALL ST. J., Aug. 27, 1991, at A6 [hereinafter *Japan Disclosure*].

about [the payback schemes] but didn't do a thing."<sup>169</sup> Moreover, in a 1984 Annual Report, the Ministry of Finance disclosed that the compensation practice was limited.<sup>170</sup> Only in December 1989, a Ministry of Finance guideline hinted that the use of such payments should be avoided.<sup>171</sup> The impact of this guideline was of little consequence.<sup>172</sup> After all, a former Nomura Securities Co. trader explained, the "MOF would find out about paybacks and warn the securities firms. The firms would promise to stop and then do the same thing all over again."<sup>173</sup> Discussing the role of the MOF in the securities enforcement area, an executive of a medium-sized securities firm proffers that the Japanese government's practice of sanctioning firms and subsequently having the securities firms hire former MOF officials signifies the MOF is sometimes highly unethical.<sup>174</sup> Due to the growing view that the revolving-door and close relationship between the securities firms and the MOF is improper, Mitsuya Matsukawa, chairman of Nikko Securities Co.'s research institute, suggests such ties are on the decline.<sup>175</sup>

The economic reverberations of this scandal will soon be understood by the Big Four: "More than 125 public organizations and utilities reportedly have announced that they will stop doing business [with the big four]."<sup>176</sup> Moreover, small investors may now view the Tokyo Stock Exchange "as rigged in favor of the big players."<sup>177</sup> In addition, the effects of suspicions of interlocking commitments in the Japanese stock market are quite real.<sup>178</sup> For instance, in September 1991, The World Bank re-

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<sup>169</sup> Shoji, *supra* note 25, at 4.

<sup>170</sup> *Japan Disclosure*, *supra* note 168, at A6.

<sup>171</sup> *Id.*; Shoji, *supra* note 25, at 4.

<sup>172</sup> Shoji, *supra* note 25, at 4.

<sup>173</sup> *Id.* "Japan's financial sector operates on shady guidelines. That includes MOF, says Keisuke Inaba, president of UBS Philips & Drew International in Tokyo." *Id.*

<sup>174</sup> *Id.*

<sup>175</sup> Blustein, *Eclipse*, *supra* note 77, at H1. Professor Shoichi Royama of Osaka University suggests that observers of the MOF fall into two groups. "One sees the government with the power and control: MOF decides, and the banks and securities houses follow . . . . The other group views MOF as a captive audience, reacting to private and noncompetitive pressure." Lake, *supra* note 21, at 46.

<sup>176</sup> Blustein, *Japanese Scandal Widens*, *supra* note 153, at D4.

<sup>177</sup> Blustein, *Firms Concede Favoritism*, *supra* note 142, at D1.

<sup>178</sup> Paul Blustein, *In Japan, A Market Dominated By Insiders*, WASH. POST, June 26, 1991, at F3.



moved Nomura Securities Company and Nikko Securities Company from a billion-dollar bond underwriting group because of their alleged ties to the Japanese syndicate.<sup>179</sup> Furthermore, due to their alleged illicit activities Japanese securities firms may face civil law suits, including those by U.S. pension funds.<sup>180</sup>

Similarly, Nobuhiko Matsuno, Director-General of the Ministry of Finance's Securities Bureau, expressed before a special committee of the Upper House of Japan's Diet (parliament), that transgressions of securities firms are of a larger scale than previously believed.<sup>181</sup> In particular, Mr. Matsuno discussed the allegations that the Nomura Securities Co. manipulated stock prices and compensated clients.<sup>182</sup> Whereas earlier the Ministry of Finance suggested that various securities firms failed to comply with legally non-binding Ministry of Finance directives, there is increasing evidence that Nomura manipulated the stock value of Tokyu Corporation for the Japanese syndicate.<sup>183</sup> Also, Mr. Matsuno proffered that Japanese securities firms had also reimbursed clients, who had not lost money, thereby illegally

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Approximately 70 percent of the stock of major Japanese companies is held by other companies in a web of cross ownership aimed at providing firms with 'stable' stockholders, which are usually business allies as well. Companies buy each other's shares not solely for obtaining high profits on their investments, but also to benefit from gaining a reliable customer or supplier, or banker.

*Id.* Nevertheless, "all stock markets are basically run by and for the benefit of big wheeler-dealers and investment funds - even when securities firms are not giving illegal rebates." Hobart Rowen, *Scandal, Japanese Style: Looking The Other Way*, WASH. POST., June 30, 1991, at H1.

<sup>179</sup> *World Bank Group Drops 2 Japanese Securities Firms*, N.Y. TIMES, Sept. 13, 1991, at D16.

<sup>180</sup> James A. White, *Pension Funds Are Urged To Sue Japanese Brokers*, WALL ST. J., Oct. 28, 1991, at C1. "In an unusual mass solicitation conducted last week, Coudert [Brothers] lawyers made a pitch to a Manhattan hotel meeting room packed with representatives of pension funds holding combined assets of some \$ 300 billion." *Id.*

<sup>181</sup> Clay Chandler, *Japan Finance Minister's Harsher Tone Suggests New Suspicions of Wrongdoing*, WALL ST. J., Sept. 3, 1991, at A14 [hereinafter Chandler, *Wrongdoing*]. "Last month, examiners from the ministry's compliance division launched surprise raids on the headquarters of the nation's four largest securities companies; their inspection of documents from the firms is continuing." *Id.*

<sup>182</sup> *Id.*

<sup>183</sup> *Id.* "We are paying attention to the fact that Nomura recommended buying Tokyu shares soon after massive purchases by criminal organizations," Mr. Matsuno said. "At this moment, we can't prove Nomura purposely drove up share prices so the criminal organizations could sell at high prices, but we have a suspicion." *Id.*

guaranteeing profits.<sup>184</sup> More specifically, Mr. Matsuno noted fifty-nine cases in which compensation may have been paid by the securities firms.<sup>185</sup>

In addition to a Ministry of Finance investigation into Nomura's activities in Tokyu Corporation stock, the Ministry of Justice's criminal division is studying this matter.<sup>186</sup> The sanctions available to the Ministry of Justice if Nomura is determined "to have engaged in manipulation, a criminal offense, the individuals involved could be sentenced to three-year prison terms and the firm could face an array of harsh administrative measures . . . includ[ing] suspensions or even the revocation of its operating license."<sup>187</sup> Moreover, Japanese securities law forbids brokerage firms from promising to compensate customer losses in advance.<sup>188</sup> To reiterate, compensation may occur if no decision to provide such money is made in advance.<sup>189</sup> Also, as stated earlier, in December 1989 the Ministry of Finance had already "issued a nonbinding directive . . . warning securities firms against paying compensation."<sup>190</sup>

Furthermore, the breadth of customer compensation by the Big Four was better understood following the testimony of top officials of these securities firms before the Special Committee.<sup>191</sup> Earlier, when allegations of wrongdoing by the Big Four arose, they admitted that during a two-and-one-half year period that ended March 1990, they provided some clients with compensation for losses suffered in stock trading.<sup>192</sup> Yet, former president of Nomura Securities, Setsuya Tabuchi, suggested that the Ministry of Finance has alleged that compensation to clients may have continued after March 1990.<sup>193</sup> Also, Mr.

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<sup>184</sup> *Id.*

<sup>185</sup> Yuri Kageyama, *Japanese: More Gained In Scandal*, WASH. POST, Sept. 3, 1991, at E1.

<sup>186</sup> James Sterngold, *Nomura Inquiry Reopened Amid Additional Findings*, N.Y. TIMES, Sept. 4, 1991, at D1 [hereinafter Sterngold, *Inquiry Reopened*].

<sup>187</sup> *Id.*

<sup>188</sup> Sterngold, *Inquiry Reopened*, *supra* note 186, at D18.

<sup>189</sup> *Id.*

<sup>190</sup> Yumiko Ono, *Big Four Officials In Japan Admit Wider Compensation Payments*, WALL ST. J., Sept. 5, 1991, at A11.

<sup>191</sup> *Id.*

<sup>192</sup> *Id.*

<sup>193</sup> *Id.*

Tabuchi claimed that it was Nomura's compensated clients who must have known about the paybacks.<sup>194</sup> Similarly, the president of Daiwa Securities Company, Masahiro Dozen, acknowledged that there existed cases of client compensation that occurred after March 1990.<sup>195</sup> In addition, Nikko Securities' former president, Takuya Iwasaki, admitted that his firm had sold shares of a speculative stock, Honshu Paper Company, to Susumu Ishii during October-November 1990.<sup>196</sup> Yet, Mr. Iwasaki stressed that his firm neither recommended the purchase nor financed the sale.<sup>197</sup>

On September 24, 1991, Ryutaro Hashimoto, the Minister of Finance, suspended Japan's Big Four securities firms from participating in Japanese government bond auctions for one month.<sup>198</sup> If the auctions proceeded as expected, the Big Four would miss three auctions of government bonds—those maturing in ten years, six months, and three months.<sup>199</sup> Apparently, the Ministry of Finance was determined to assign these sanctions after the Big Four acknowledged that since April 1990 they had provided eighty major clients with more than \$325 million to compensate them for securities trading losses.<sup>200</sup> In particular, the Ministry of Finance argued that its December 1989 administrative guidance against such compensation was willfully ignored by the Big Four.<sup>201</sup> As Kichiro Takao, the president of Nikko

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<sup>194</sup> *Id.* See Nomura Wrongly Promoted Shares President Admits, WALL ST. J., Sept. 8, 1991, at A18.

<sup>195</sup> Ono, *supra* note 190, at A11.

<sup>196</sup> *Id.*

<sup>197</sup> *Id.*

<sup>198</sup> Paul Blustein, 'Big Four' Bond Trading Suspended, WASH. POST, Sept. 25, 1991, at C2 [hereinafter Blustein, *Bond Trading*]; Quentin Hardy & Clay Chandler, *Four Japanese Broker Firms Disciplined*, WALL ST. J., Sept. 25, 1991, at C1 [hereinafter Hardy & Chandler]; James Sterngold, *New Penalty Is Planned For Japan Brokerages*, N.Y. TIMES, Sept. 25, 1991, at D6 [hereinafter Sterngold, *New Penalty*]. The Big Four were sanctioned with "a four-day suspension from brokerage activities in July [1991]". Blustein, *Bond Trading*, *supra*, at C2.

<sup>199</sup> Hardy & Chandler, *supra* note 198, at C14.

<sup>200</sup> Blustein, *Bond Trading*, *supra* note 198, at C2. "Daiwa, the second-largest of the Big Four, admitted today to compensating clients about \$176 million since April 1990. Yamaichi confessed to paying about \$123 million during the period; Nikko acknowledged paying \$24.6 million; and Nomura, the world's largest securities firm, admitted to paying \$3 million."

<sup>201</sup> *Id.* "But critics have asserted that the powerful ministry must have known of the compensation practice and decided to turn a blind eye to it to help the firms protect

Securities Company, admitted, "[i]t is wrong that we ignored the Finance Ministry's directive. We failed in making all employees strictly follow the directive." <sup>202</sup>

This suspension harms the Big Four's reputation.<sup>203</sup> Nevertheless, due to the Big Four's dominance in Japanese government and corporate underwriting, the Ministry of Finance cannot keep them out of the auctions for an extended period.<sup>204</sup> After all, as Alica Ogawa, a financial analyst at S.G. Warburg Securities Ltd. in Tokyo surmises, "[t]here isn't any infrastructure to replace them." <sup>205</sup>

Bad news continued for Japan's financial industry when on September 30, 1991 the Ministry of Finance formally accused Nomura Securities Company of violating "an article of the securities law prohibiting 'excessive sales recommendations' as well as a 1974 guideline urging securities companies to run their businesses in consideration of their clients' best interests."<sup>206</sup> This accusation was based on a stock scheme, discussed earlier, in which Nomura allegedly "arranged for an affiliated company to provide more than \$100 million in financing to a gangster, Susumu Ishii, and then to have helped him accumulate more than twenty-seven million shares in the Tokyu Corporation . . . ." <sup>207</sup> Next, Nomura apparently "issued a strong buy recommendation for Tokyu and held seminars in October 1989, in which top executives pushed the stock heavily."<sup>208</sup> Subsequently, Nomura's offices supposedly acquired a large number of buy orders. As a result, the price of Tokyu Company's stock doubled during the autumn of 1989.<sup>209</sup> Soon afterwards, Mr. Ishii allegedly unloaded a large portion of his Tokyu Company stock at

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their relationships with their clients."

<sup>202</sup> Sterngold, *New Penalty*, *supra* note 198, at D6.

<sup>203</sup> Hardy & Chandler, *supra* note 198, at C1. Marshall Gittler, bond market analyst at UBS Phillips & Drew International Ltd. suggests "The people in charge of supervising them are saying they won't deal with them."

<sup>204</sup> *Id.*

<sup>205</sup> *Id.*

<sup>206</sup> Quentin Hardy, *Tokyo Agency Curbs Nomura's Stock Trading*, WALL ST. J., Oct. 1, 1991, at A16. See James Sterngold, *Japan Accuses Nomura of Stock-Price Scheme*, N.Y. TIMES, Oct. 1, 1991, at D2 [hereinafter Sterngold, *Nomura*].

<sup>207</sup> Sterngold, *Nomura*, *supra* note 206, at D2.

<sup>208</sup> *Id.*

<sup>209</sup> *Id.*

inflated prices.<sup>210</sup> Rather quickly, Tokyu's share price fell, causing most of the securities firm's customers losses.<sup>211</sup>

Due to its actions in the Tokyu Corporation stock manipulation scheme, the Ministry of Finance ordered Nomura Securities Company to shut down seventy-nine domestic offices for one month as well as eight other branches for six weeks.<sup>212</sup> In addition, Nomura was ordered to close down its research division and to stop trading on its own account for one month.<sup>213</sup> Also, Nomura's suspension for underwriting government bonds was extended through November 1991.<sup>214</sup> Nomura's president, Hideo Sakamaki, acknowledged the firm's wrongdoing and apologized for causing the firm's clients so much trouble.<sup>215</sup> This latest admonishment by the Ministry of Finance of Nomura's activities will likely tarnish its image.<sup>216</sup> As one executive at a foreign securities firm in Japan noted, Nomura is "going to feel this one, both at home and overseas, where a lot of people are wondering if they should be doing business with these kinds of people."<sup>217</sup>

In fact, due to the scandal, profits at the Big Four and various medium-sized firms were down in April—September 1991.<sup>218</sup> Reduced trading volume and declining customer confidence were major factors in declining profitability.<sup>219</sup> More specifically, during April—September 1991, Yamaichi Securities Co. posted a loss of 5.42 billion yen (\$41 million).<sup>220</sup> For the same period, the pre-tax earnings of Nomura Securities Co. was posted at 39.76 billion yen, a decline of some 64% from the previous year.<sup>221</sup> Also, financial declines were apparent at Daiwa Securities Co.: pre-tax profits declined some "70% to 20.62 billion yen."<sup>222</sup> Analogously, Nikko Securities Co.'s pre-tax profits fell 64% to

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<sup>210</sup> *Id.*

<sup>211</sup> *Id.*

<sup>212</sup> James Sterngold, *Nomura Gets Big Penalties*, N.Y. TIMES, Oct. 9, 1991, at D1.

<sup>213</sup> *Id.*

<sup>214</sup> *Id.*

<sup>215</sup> *Id.*

<sup>216</sup> *Id.* at D5.

<sup>217</sup> *Id.*

<sup>218</sup> Quentin Hardy, *Japan's Big Four Brokerage Firms Show Weakness*, WALL ST. J., Oct. 24, 1991, at A12 [hereinafter Hardy, *Firms Show Weakness*].

<sup>219</sup> *Id.*

<sup>220</sup> *Id.*

<sup>221</sup> *Id.*

<sup>222</sup> *Id.*

12.05 billion yen. Despite these disappointing figures, Norio Yamaguichi of ABN AMRO Securities (Japan) explained that they were not a significant problem for the Big Four.<sup>223</sup> After all, according to financial analyst Alicia Ogawa of S.G. Warburg Securities (Japan), these firms are well-capitalized and can overcome hardship.<sup>224</sup>

However, medium-sized Japanese securities firms are viewed to be in more serious trouble. They do not possess the financial assets of the Big Four.<sup>225</sup> Thus, particularly ominous is that of the six largest second-tier securities firms only one earned a profit during April–September 1991.<sup>226</sup> In particular, Kankoku Securities Co.'s pre-tax profits fell 90%, from 23.50 billion yen the previous year, to 2.39 billion yen.<sup>227</sup> Another firm, New Japan Securities, had the largest loss of that tier of firms during April–September 1991, 20.28 billion yen.<sup>228</sup>

Continued publicity about the scandals which hit the Japanese financial community continued in 1992.<sup>229</sup> More specifically, in January 1992, Nui Onoue, an Osaka restaurateur, pleaded guilty to defrauding some \$1.45 billion from a number of Japanese financial institutions.<sup>230</sup> Ms. Onoue supposedly forged deposit receipts from Japanese credit unions, including Toyo Shinkin Bank.<sup>231</sup> These forged deposit receipts were used as collateral when she borrowed funds from banks, such as the Industrial Bank of Japan — a bank in which Ms. Onoue was the biggest individual stockholder — to utilize in securities speculation.<sup>232</sup> Due to the introduction of this information in the summer of 1991, the Industrial Bank of Japan's chairman, Kaneo Nakamura, was forced to resign.<sup>233</sup>

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<sup>223</sup> *Id.*

<sup>224</sup> Quentin Hardy, *Big Four Firms In Japan Slash Profit Outlooks*, WALL ST. J., Sept. 19, 1991, at A11.

<sup>225</sup> *Id.*

<sup>226</sup> Hardy, *Firms Show Weakness*, *supra* note 218.

<sup>227</sup> *Id.*

<sup>228</sup> *Id.*

<sup>229</sup> *Osaka Woman Admits Guilt In \$1.45 Billion Loan Scam*, WALL ST. J., Jan. 24, 1992, at A11.

<sup>230</sup> *Id.*

<sup>231</sup> *Id.*

<sup>232</sup> *Id.*

<sup>233</sup> *Id.*

Also, in February 1992, Japanese securities firms settled disputes with specific key clients, who had been promised that a repurchase of specific stocks would be made by the brokerages.<sup>234</sup> Daiwa Securities Co., in a civil arbitration, agreed to pay Tokyu Land Corp. \$28 million for the securities firm's failure to keep its promise-to-repurchase agreement involving stocks and government bonds.<sup>235</sup> Similarly, Cosmo Securities Co. agreed to pay its former client, Skylark Co., \$321 million for the brokerage's inability to honor its repurchase agreement.<sup>236</sup> These announcements by the securities firms will likely weaken their credit ratings and public images.<sup>237</sup>

#### IV. FOREIGN FINANCIAL INSTITUTIONS IN JAPAN

Foreign banks in Japan registered their worst losses in the business year ending March 31, 1990.<sup>238</sup> Part of these losses were attributed to the spectacular increase in interest rates, which raised the cost of funds in the market.<sup>239</sup> Some foreign banks attributed part of their losses to the impediments placed upon foreign financial institutions.<sup>240</sup>

In the business year ending March 1989, pre-tax profits on eighty-three foreign banks in Japan were down fifty-seven percent from the previous year.<sup>241</sup> Except for fiscal years 1985 and 1987, earnings of foreign banks in Japan declined.<sup>242</sup> Nevertheless, foreign banks in Japan are in the market for the long-term. Most foreign banks focus on their areas of expertise, such as mergers and acquisitions, financial futures or options trading.<sup>243</sup> Japanese banks, which may not be as adept in these realms of banking, are still able to take advantage of traditional banking

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<sup>234</sup> Quentin Hardy & Masayoshi Kanabayashi, *Japanese Broker Daiwa To Pay Customer \$28 Million In Securities Buy-Back Pact*, WALL ST. J., Feb. 26, 1992, at A8.

<sup>235</sup> *Id.*

<sup>236</sup> *Id.*

<sup>237</sup> *Id.*

<sup>238</sup> *Higher Rates Blamed For Big Losses By Foreign Banks*, KYODO NEWS SERVICE, July 19, 1990.

<sup>239</sup> *Id.*

<sup>240</sup> *Id.* See also Nobuo Takahashi, *Despite Red Inc, Foreign Banks Undismayed*, JAPAN ECON. J., Aug. 26, 1989, at 2.

<sup>241</sup> Takahashi, *supra* note 240.

<sup>242</sup> *Id.*

<sup>243</sup> *Id.*

sectors.<sup>244</sup> In this arena, Japanese banks with strong connections to Japanese corporations are able to influence and obtain their client's business.<sup>245</sup> Japanese banks can own up to five percent of the equity of client companies; therefore it is difficult for foreign banks to compete against Japanese banks.<sup>246</sup> As a result, foreign banks have shied away from these banking sectors.<sup>247</sup> However, foreign banks assist Japanese clients with "international operations such as swap trading, serving as an intermediary in M&A activities and underwriting securities issued on overseas markets."<sup>248</sup> The period of March-September 1989 was particularly profitable for many foreign securities firms such as Kidder Peabody and Salomon Brothers.<sup>249</sup> A number of foreign securities firms, including Jardine Fleming and Morgan Stanley, have been particularly successful in brokering equity warrant transactions.<sup>250</sup> Moreover, American firms have done well by utilizing sophisticated computer programs in various trading in stock index futures and option instruments.<sup>251</sup> Also, Salomon Brothers and other foreign firms have obtained more than thirty percent of the ten-year government bond market.<sup>252</sup>

Additional actions by the Ministry of Finance have enabled foreign securities firms to gain a larger foothold in the TSE.<sup>253</sup> More specifically, in 1989, the Ministry of Finance limited "the monthly trading of any single domestic broker . . . in a particular issue to less than [thirty percent] of the stock's total volume."<sup>254</sup> Consequently, the impact of the Big Four in any single stock was reduced, thereby enabling foreign firms and smaller domestic firms to enter the market.<sup>255</sup>

Not all foreign securities firms desire to become full mem-

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<sup>244</sup> *Id.*

<sup>245</sup> *Id.*

<sup>246</sup> *Id.*

<sup>247</sup> *Id.*

<sup>248</sup> *Id.*

<sup>249</sup> *Foreign Securities Firms In Japan: Gilded Seats*, *ECONOMIST*, Jan. 6, 1990, at 78.

<sup>250</sup> *Id.*

<sup>251</sup> *Id.*

<sup>252</sup> *Id.*

<sup>253</sup> *Id.*

<sup>254</sup> *Id.*

<sup>255</sup> *Id.*



bers of the Tokyo Stock Exchange.<sup>256</sup> After all, some firms, such as Chase Manhattan, argue that the TSE entry fee of \$6.8 million — approximately seven times the New York Stock Exchange price — is too high.<sup>257</sup> Yet, the Ministry of Finance has found fault in some of the foreign securities firms' activities, particularly "booking their trades offshore and then charging the settlement costs and other regional overheads to their Tokyo offices."<sup>258</sup>

The securities scandal involving Japanese firms was partly responsible for gains by foreign securities firms in 1991.<sup>259</sup> More specifically, some Japanese institutional investors and foreign entities, which formerly utilized Japanese securities firms, increasingly used the services of foreign securities firms.<sup>260</sup> In fact, in June 1991, fifteen percent of the turnover on the Tokyo Stock Exchange was based on foreign securities firms.<sup>261</sup> Indeed, in 1991, U.S. securities firms in Japan had an excellent year. Salomon Brothers, Goldman Sachs, and Morgan Stanley ranked among the top five most profitable securities brokers for the fiscal year ending March 1992.<sup>262</sup> Nine of the top ten foreign securities firms recorded profits for the period March—September 1991. In contrast, thirty-seven of forty-seven Japanese securities firms reported losses for the period March—September 1991.<sup>263</sup>

#### VI. COMPLAINTS BY FOREIGN FINANCIAL INSTITUTIONS REGARDING THEIR TREATMENT IN JAPAN

The Institute of Foreign Bankers in Japan (Institute) set out a list of proposals in response to key complaints that foreign banking institutions in Japan have experienced.<sup>264</sup> First, in response to foreign banks' complaints that funding capabilities

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<sup>256</sup> *Id.*

<sup>257</sup> *Id.*

<sup>258</sup> *Id.*

<sup>259</sup> Hugh Levinson, *Scandals Bring In Business For Foreign Securities Firms*, JAPAN TIMES WEEKLY INT'L EDIT., Aug. 26-Sept. 1, 1991, vol. 31, num. 34.

<sup>260</sup> *Id.*

<sup>261</sup> *Id.*

<sup>262</sup> Ted Holden, *Is Tokyo Getting Tough — Or Getting Jealous?*, BUS. WK., May 25, 1992, at 110.

<sup>263</sup> Tony Shale, *The Gaijin Steam In*, EUROMONEY, Jan. 1992, at 16-20.

<sup>264</sup> NATALIE OHNISHI, JAPAN MARKET ACCESS POST-ACTION PROGRAM: THE LIBERALIZATION OF THE JAPANESE FINANCIAL AND CAPITAL MARKETS 60 (1987).

were inadequate, the Institute called for the establishment "of a free Yen interbank market in Tokyo similar to the Dollar interbank market in New York (Fed Funds Market) or in London (Euro-Dollar Market) . . . ."<sup>265</sup> Also, the Institute suggested the deregulation of interest rates.<sup>266</sup> It asserted that recent attempts to change interest rates on significant deposits and certificates of deposits (CDs) were insufficient.<sup>267</sup> Furthermore, the Institute suggested that the Bank of Japan "should play the role of lender of last resort and provider of liquidity also for foreign banks."<sup>268</sup>

Second, the Institute addressed the foreign banks' need to further liberalize the Euro-Yen market.<sup>269</sup> This requires a "free creation of borrowing and investment instruments by the market participants . . . as well as free access by borrowers and investors to these instruments."<sup>270</sup> Third, the Institute suggested that Japan's securities business must be liberalized: to include procedures to easily obtain permission to underwrite and trade government bonds; to include other instruments, such as floating rate and interbank deposits when trading government bonds; and to increase securitization of financial assets and liabilities.<sup>271</sup> Fourth, the Institute applauded preliminary plans to create Tokyo Offshore Banking Units.<sup>272</sup> Such financial instruments would establish the necessary tax incentives that have made the international banking facilities in New York successful.<sup>273</sup> Fifth, the Institute suggested that foreign banks be granted bank licenses more freely.<sup>274</sup> This would be achieved by utilizing a reciprocity system of banking regulation.<sup>275</sup> Also, there were apprehensions about regulating foreign financial institutions in Japan.

Similarly, in a 1986 White Paper, the American Chamber of Commerce in Japan (Chamber) highlighted foreign financial institutions' concerns in the Japanese financial market. In particu-

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<sup>265</sup> *Id.*

<sup>266</sup> *Id.*

<sup>267</sup> *Id.*

<sup>268</sup> *Id.*

<sup>269</sup> *Id.*

<sup>270</sup> See generally *Exchange Rate Issues*, *supra* note 8, at § (V)(C).

<sup>271</sup> OHNISHI, *supra* note 264, at 61.

<sup>272</sup> *Id.*

<sup>273</sup> *Id.*

<sup>274</sup> *Id.*

<sup>275</sup> *Id.*

lar, the Chamber suggested the following:

[i]nterest rate liberalization below the 100 million yen deposit level; [c]reation of a meaningful Yen Treasury bill market; [f]urther access to Trust Banking and Pension Fund Management business; [a]dditional membership in the Tokyo Stock Exchange by foreign firms; [a]bility of branches of foreign securities firms to participate in Tokyo foreign exchange market; [f]ree data transmission not allowed between banks and customers; [b]ill discount market which does not adequately reflect the market supply and demand forces at all times; [l]imits on overnight foreign exchange exposure that are too restrictive in light of the dramatic expansion of the size and activity of the Tokyo market; [t]ransfer tax which still exists on certain securities; [f]urther progress needed to eliminate redundant reports; [r]ules for establishment of securities firms with foreign bank ownership not clearly stated or uniformly applied; [c]reation of an unrestricted yen interbank market without collateral requirements; [f]ull liberalization of the yen in the international markets to allow yen funds raised in international markets to be freely used in Japan; [u]nfavorable tax treatment of earnings in proposed Tokyo offshore banking unit legislation; [e]nhancement of the clearance system for all securities; [e]stablishment of a foreign currency options market; and [i]mproved participation by foreign branches of securities firms in the domestic underwriting markets.<sup>276</sup>

Furthermore, foreign banks have raised complaints regarding the extensive control which Japanese banks have over the latter's clients.<sup>277</sup> Of the 1,612 companies listed on the Tokyo Stock Exchange, seventy-eight percent of market capitalization (or 1,100 companies) can be designated as comprising a keiretsu.<sup>278</sup> The bank-centered keiretsu, which makes up 61% of

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<sup>276</sup> AMERICAN CHAMBER OF COMMERCE IN JAPAN, 1986 UNITED STATES- JAPAN WHITE PAPER 42 (1987) [hereinafter WHITE PAPER].

<sup>277</sup> Tony Shale, *Reawakening The Sleeping Giant*, EUROMONEY, Nov. 1990, at 14 [hereinafter Shale, *Sleeping Giant*].

<sup>278</sup> *Id.* at 16. The keiretsu arrangement is:  
the complex cross-shareholding structure that characterizes the Japanese financial system.

...  
Keiretsu have their historical roots in the pre-World War II *zaibatsu* industrial groupings established among such old families as the Yasudas, Sumitomos, and Mitsubishis. The *zaibatsu* were broken up during the American occupation only to be replaced by the interlocking shareholdings between banks and their

market capitalization (or 846 companies) includes the following major Japanese banks: DKB (7.6% market capitalization); Fuyo (7.1% market capitalization); Mitsubishi (11.0% market capitalization); Mitsui (9.8% market capitalization); Sanwa (5.8% market capitalization); Sumitomo (10.7% market capitalization); Tokai (1.0% market capitalization); and IBJ (7.8% market capitalization).<sup>279</sup> The purpose of bank-centered keiretsu is “‘to rebuild zaibatsu ties, to guarantee a company access to bank financing and to protect a company from takeovers.’”<sup>280</sup> Robert Zielinski, a senior analyst at Jardine Fleming Securities in Tokyo, stated that the Japanese banks are refurbishing the zaibatsu system, which stems from their aim to dissuade foreign competition, while redesigning some backwards Japanese business sectors.<sup>281</sup>

While foreign financial institutions have expressed the above concerns, Japanese banks and institutions have had success abroad. For example, the Mitsubishi industrial group has made some huge overseas acquisitions.<sup>282</sup> In 1990, “Mitsubishi Estate bought 57.6% of the Rockefeller Plaza for \$960 million; Mitsubishi Corporation bought control of Aristech Chemical for \$877 million . . . and Mitsubishi Trust & Banking was the main lender in the \$940 million purchase of the Pebble Beach Golf course . . . .”<sup>283</sup>

In 1992, Japanese regulators took measures to make securities trading more expensive and difficult.<sup>284</sup> In particular, the Ministry of Finance targeted the index arbitrage arena, in which gains are made from price differences between the price of the

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commercial borrowers that characterize the keiretsu.

Marshall Auerback, *Japan Inc.'s Days Are Numbered*, WALL ST. J., Sept. 3, 1991, at A18. See generally *Keiretsu and Other Large Corporate Groups in Japan*, JAPAN ECON. INST. REP., Jan. 12, 1990, No. 2A at 3; Robert Neff & William J. Holstein, *Mighty Mitsubishi Is On The Move: Its Hundreds Of Interdependent Companies Are Building An Empire That Stretches From Rockefeller Center To Riyadh*, BUS. WK., Sept. 24, 1990, at 98.

<sup>279</sup> Shale, *Sleeping Giant*, *supra* note 277, at 16.

<sup>280</sup> *Id.*

<sup>281</sup> *Id.* at 17.

<sup>282</sup> *Id.* at 18; Shale, *Sleeping Giant*, *supra* note 277, at 18.

<sup>283</sup> *Id.* See William J. Holstein et al., *Hands Across America: The Rise of Mitsubishi*, BUS. WK., Sept. 24, 1990, at 102.

<sup>284</sup> Ted Holden, *Is Tokyo Getting Tough — Or Getting Jealous?*, BUS. WK., May 25, 1992, at 110. [hereinafter *Tokyo Getting Tough*].

index future and its underlying basket of stocks.<sup>285</sup> According to some reports, the Ministry of Finance would seek higher taxes on profits arising from index arbitrage.<sup>286</sup> Also, perhaps the Nikkei Stock Index would be amended into a capital-weighted index, as the Standard & Poor's 500.<sup>287</sup> In doing so, index arbitrage would be more costly since it would be more complex to forge a small group of stocks that would follow the newly-devised Nikkei Stock Index.<sup>288</sup> Also, at the Osaka Stock Exchange, where futures contracts on the Nikkei 225 index are traded, margin requirements and commissions were raised.<sup>289</sup> Such adjustments, American securities firms contend, are aimed at reducing their profitability.<sup>290</sup>

Also, the Ministry of Finance has been slow to allow entry by foreign firms in the mutual fund industry.<sup>291</sup> Yet, in 1992, the Ministry of Finance reviewed whether to reduce the minimum capitalization of foreign mutual funds from \$8 million to \$2.5 million.<sup>292</sup> Such a change would be welcome although not as palatable as the \$100,000 minimum capitalization requirements on U.S. mutual funds.<sup>293</sup> Also, U.S. fund managers, unlike fund managers in Japan, may determine their own fees.<sup>294</sup> With such restrictions, the Chief Counsel of Fidelity, Robert Pozen, suggests, " 'There's still a very significant barrier to entry. It's a far cry from an open market.' " <sup>295</sup>

## VI. JAPANESE RESPONSE TO COMPLAINTS REGARDING RESTRICTIONS ON FOREIGN BANKING INSTITUTIONS

In response to the complaints by foreign financial institutions in Japan regarding the treatment they received, the Japanese Ministry of Finance promised increased access and liberali-

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<sup>285</sup> *Id.*

<sup>286</sup> *Id.*

<sup>287</sup> *Id.*

<sup>288</sup> *Id.*

<sup>289</sup> *Id.*

<sup>290</sup> *Id.*

<sup>291</sup> *Id.*

<sup>292</sup> *Id.*

<sup>293</sup> *Id.*

<sup>294</sup> *Id.*

<sup>295</sup> *Id.*

zation in Japanese financial markets.<sup>296</sup> In particular, the Ministry of Finance focused on allowing foreign firms increased membership on the Tokyo Stock Exchange (TSE), increased access to government bond issues, reduced barriers to entry into the trust and pensions business, increased access to Japanese securities markets, and licenses for discretionary investment management.<sup>297</sup>

First, an Ad Hoc Committee on Membership Structure was created at TSE to discuss increasing the number of foreign members. From its inception in April 1949 until April 1982, the TSE charter contained provisions denying foreigners membership on the Exchange.<sup>298</sup> Furthermore, because the TSE, like other stock exchanges, is a non-governmental institution, the pressure that the Japanese government could place on the Exchange was limited.<sup>299</sup> Yet, there is an important distinction between entry into the TSE and the New York Stock Exchange (NYSE): "the NYSE is open to all qualified applicants willing to pay the price of a membership, whereas new membership in the TSE [is] tightly controlled and thus unavailable even to parties willing to pay the price."<sup>300</sup> Prior to 1985 when six foreign firms became TSE members, foreign securities firms operating in Japan did not have a seat at the TSE because all the spaces were occupied.<sup>301</sup> As a result, these foreign securities firms lacked the financial benefits intertwined with this designation.<sup>302</sup> For these foreign securities firms, the lack of a TSE seat meant that they could not finalize contracts, underwrite primary offerings of Japanese securities, or execute orders without paying broker commissions.<sup>303</sup>

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<sup>296</sup> Ohnishi, *supra* note 264, at 56.

<sup>297</sup> See *infra* notes 298-324 and accompanying text.

<sup>298</sup> GAO, *International Finance: Market Access Concerns of U.S. Financial Institutions in Japan*, March 1988, at 13 (United States Government Accounting Office)[hereinafter GAO].

<sup>299</sup> Semkow, *supra* note 1, at 57.

<sup>300</sup> GAO, *supra* note 298, at 15.

<sup>301</sup> *MOF Decides To Allow Foreign Members To TSE*, JAPAN ECON. J., May 28, 1985, at 4; E.S. Browning and Chipello, *Non-Japanese Firms Begin Push To Win Seats On Tokyo Exchange*, WALL ST. J., Oct. 25, 1985, cited in Semkow, *supra* note 1, at 57.

<sup>302</sup> Barbara Thomas, *Capital Formation in Japan and the United States: A Comparative Assessment*, 21 COLUM. J. TRANSNAT'L L. 227, 234 (1983).

<sup>303</sup> Browning, *Tokyo Exchange: To Join or Not To Join*, WALL ST. J., Sept. 27, 1985, at 32, cited in Semkow, *supra* note 1, at 57.

To reiterate, it was not until November 1985 that foreign firms became members in the TSE.<sup>304</sup> Of the six foreign firms allowed entry, four were American: Goldman Sachs, Merrill Lynch, Morgan Stanley, and Citicorp's London-based affiliate, Vickers da Costa Ltd.<sup>305</sup> In December 1987, sixteen additional foreign securities firms were admitted to the TSE, six of which were American: Salomon Brothers, First Boston, Shearson Lehman Brothers, Kidder Peabody, Smith Barney, and Prudential Bache.<sup>306</sup> The TSE explained that it admitted foreign securities firms based on "the applicant's financial standing, past business performance, and experience in the Japanese secondary market."<sup>307</sup>

Second, access to government bond issues by foreign financial institutions increased, thus easing foreign banks' ability to purchase and sell Japanese government securities to the secondary market.<sup>308</sup> Also, foreign financial institutions were provided a larger role in underwriting secondary government securities.<sup>309</sup> However, foreign participation in the Japanese government bond sector continued to be marginal.<sup>310</sup>

To counter the dissatisfaction regarding limited access to the ten-year Japanese government bonds, Japan has raised foreign securities firms' percentage of bonds distributed through the underwriting syndicate.<sup>311</sup> Yet, foreign financial institutions, including U.S. firms, have been unable to persuade Japan to approve "a full auction process for government bonds in which issue terms are freely determined through open market competition."<sup>312</sup>

Third, Japanese barriers on foreign banks were placed upon the growing sector of managing trust and pension funds.<sup>313</sup> For example, a proposed joint venture between Nomura Securities and Morgan Guaranty Trust that would permit them to work

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<sup>304</sup> GAO, *supra* note 298, at 13.

<sup>305</sup> *Id.* n.2.

<sup>306</sup> *Id.*

<sup>307</sup> *Id.* at 13-14.

<sup>308</sup> Ohnishi, *supra* note 264, at 56.

<sup>309</sup> *Id.*

<sup>310</sup> GAO, *supra* note 298, at 15.

<sup>311</sup> *Id.* at 16.

<sup>312</sup> *Id.*

<sup>313</sup> Frankel, *supra* note 8, at 46, *citing*, EXCHANGE RATE ISSUES, *supra* note 9.

together in the trust sector was dismissed.<sup>314</sup> The response to the Nomura/Morgan proposal deterred similar initiatives by Bank of America and Nikko Securities, Citicorp and Daiwa Securities, and Yamaichi Securities and Chemical Bank.<sup>315</sup> U.S. interest in entering the trust banking area was due in part from the Japanese pension fund market valued at \$200 billion.<sup>316</sup> The U.S. Department of Treasury and the Japanese Ministry of Finance responded to this denial by issuing a May 1984 Report on the Yen/Dollar Exchange Rate Issues.<sup>317</sup>

More specifically, the Yen/Dollar Report provided that the Japanese would treat foreign commercial banks better than such Japanese financial institutions.<sup>318</sup> More specifically, foreign commercial banks entering the trust area in the United States inspired this liberalization of laws regulating foreign financial institutions in Japan.<sup>319</sup>

The Ministry of Finance's rationale for dismissing the joint venture stemmed from long-term opposition to permitting Japanese commercial banks to enter the trust banking arena.<sup>320</sup> In Japan, separation between trust and commercial banks is as important as those between commercial and investment banks in the United States. However, the United States perceived this rejection as a mere continuation of previous Japanese restrictive practices.<sup>321</sup>

Also, in order to increase their access to Japan's finance markets, the Ministry of Finance agreed to permit additional foreign securities companies and experienced foreign investment management companies to enter Japan.<sup>322</sup> Such actions helped Japan internationalize its capital markets. Despite these

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<sup>314</sup> *Finance Minister OK To Nomura Morgan Plan; Says It's Long-Range Issue*, JAPAN ECON. J., Mar. 20, 1984, at 2; Semkow, *supra* note 1, at 46.

<sup>315</sup> *Citicorp Plans To Enter Trust Business in Japan*, JAPAN ECON. J., Jan. 10, 1984, at 1; Semkow, *supra* note 1, at 47.

<sup>316</sup> *Foreign Trust Banks Bolster Japan Preserved*, JAPAN ECON. J., Aug. 29, 1987.

<sup>317</sup> EXCHANGE RATE ISSUES, *supra* note 9, § (V)(B) Introduction.

<sup>318</sup> Semkow, *supra* note 1, at 59.

<sup>319</sup> *Only U.S. Banks Acting On Their Own Can Enter Japan's Trust Market*, JAPAN ECON. J., May 8, 1984 at 1.

<sup>320</sup> Katz, *Industrial Policy Implications of Japan's Credit Structure Is More Important Than Yen Rate*, JAPAN ECON. J., May 8, 1984, at 20; Semkow, *supra* note 1, at 47.

<sup>321</sup> Semkow, *supra* note 1, at 47.

<sup>322</sup> Ohnishi, *supra* note 264, at 56.



changes, American banks in Japan complain that Japanese banks have an unfair competitive advantage because U.S. banking regulators impose higher capital requirements on all U.S. banks than Japanese banking regulators impose on Japanese banks.<sup>323</sup>

## VII. RECENT DEVELOPMENTS IN FINANCIAL DEREGULATION IN JAPAN

There are many recent developments in financial deregulation affecting foreign banking institutions in Japan.<sup>324</sup> First, in 1984, the Ministry of Finance placed limits on the amount of foreign exchange that both Japanese and foreign banks could convert into Japanese currency with the object of lending these funds in Japan. More specifically, effective June 1984, the Ministry of Finance ruled that previous swap limits on both foreign and Japanese banks would be terminated.<sup>325</sup> Second, in June 1985, the yen-denominated bankers acceptance market commenced.<sup>326</sup> Third, as stated earlier, in November 1985, six seats in the Tokyo Stock Exchange were allocated to foreign securities firms.<sup>327</sup> Fourth, in March 1986, the Tokyo Stock Exchange relaxed its listing requirements for large non-Japanese companies.<sup>328</sup> Fifth, in October 1986, "Bankers Trust [became] the first foreign trust bank in Japan to co-manage a major Japanese corporate pension fund."<sup>329</sup> Sixth, in December 1986, the Japan Offshore Market began: "Japan's new international banking facility's initial size of the market was about \$50 billion."<sup>330</sup> Seventh, in April 1987, the share of Japanese five-, ten-, and twenty-year government bond market for foreign securities firms expanded.<sup>331</sup>

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<sup>323</sup> GAO, *supra* note 298, at 18.

<sup>324</sup> See WHITE PAPER, *supra* note 276, at 42; Frankel, *supra* note 8, at 44-47; Edward L. Rubin, *Deregulation, Reregulation and the Myth of the Market*, 45 WASH. & LEE L. REV. 1249 (1988).

<sup>325</sup> EXCHANGE RATE ISSUES, *supra* note 8, at § (V)(A) Interest Rates (4).

<sup>326</sup> GAO, *supra* note 298, at 20; Ohnishi, *supra* note 264, at 15. See EXCHANGE RATE ISSUES, *supra* note 9, at § (V)(A) Funding and Lending (2).

<sup>327</sup> GAO, *supra* note 298, at 20.

<sup>328</sup> *Id.*

<sup>329</sup> *Id.*

<sup>330</sup> *Id.*

<sup>331</sup> *Id.*

Foreign pressure on the Ministry of Finance resulted in a significant coup in 1986.<sup>332</sup> More precisely, German banks in Japan were permitted to establish fully-functional securities operations, despite restrictions on other banks from entering the securities business.<sup>333</sup> This MOF determination arose after Germany argued that no legal impediments exist for Japanese banks in Germany to enter the securities business.<sup>334</sup> Thus, the concept of reciprocity was demonstrated in practice.<sup>335</sup> Soon too, other foreign banks were permitted to carry out activities in the securities business.<sup>336</sup> Nevertheless, the banks which conduct such work were required to establish "branch offices of securities subsidiaries incorporated outside Japan in which their shareholding does not exceed fifty percent."<sup>337</sup> Also, in permitting the foreign banking institutions to enter the Japanese securities arena, the Ministry of Finance concurrently created a loophole in Article 65 of the Securities and Exchange Law for Japanese banks.<sup>338</sup>

The impetus for the Japanese banks' interest in entering the securities business stems from their observance that their charts are increasingly utilizing the securities arena to raise funds.<sup>339</sup> As banks slowly enter the securities realm in Japan, so too are securities firms attempting to increase their role in banking.<sup>340</sup> More specifically, securities firms seek to offer products that are similar to basic bank products, such as bank deposits.<sup>341</sup> Accordingly, securities firms are interested in personal financial assistance services such as Merrill Lynch's cash management accounts.<sup>342</sup>

Also, the British strategy to accelerate the progress of the deregulation of Japanese financial markets was based on the rec-

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<sup>332</sup> Hinterhauser, *supra* note 34, at 67.

<sup>333</sup> *Id.*

<sup>334</sup> *Id.*

<sup>335</sup> *Id.*

<sup>336</sup> *Id.*

<sup>337</sup> *Id.*

<sup>338</sup> *Id.*

<sup>339</sup> *Id.*

<sup>340</sup> *Id.*

<sup>341</sup> *Id.*

<sup>342</sup> *Id.*

iprocity model.<sup>343</sup> More specifically, in November 1986, U.K. Trade and Industry Secretary Paul Channon discussed with Japan's Ministry of Finance the topics of foreign securities firms entry in Japan.<sup>344</sup> Essentially, Channon expressed that if British securities firms are denied further seats on the Tokyo Stock Exchange, the United Kingdom would revoke operating licenses of Japanese securities firms in London.<sup>345</sup>

Next, in May 1987, "permission [was] granted to four foreign securities firms to join the underwriting syndicate for yen bond issue by Nippon Telegraph and Telephone in the domestic market."<sup>346</sup> Also, in June 1987, non-majority-owned securities branches were established in Japan by U.S. banks.<sup>347</sup> In addition, in October of 1986, "Bankers Trust [became] the first foreign trust bank permitted to manage Japanese government pension funds."<sup>348</sup> Additionally, in October 1987, the Tokyo Stock Exchange announced that twenty-two new members would be added to the exchange.<sup>349</sup> Furthermore, in November 1987, forty securities firms, twenty Japanese and twenty foreign, filed membership applications with the Tokyo Stock Exchange.<sup>350</sup> During that same month, foreign dealers' share of a ten-year Japanese government bond limiting auction from 15% under the old syndicate system to about 5% increased.<sup>351</sup> Also, in November 1987, foreign banks were able to compete with Japanese banks in the commercial paper market.<sup>352</sup> In addition, in December 1987, the Tokyo Stock Exchange announced that it would grant membership to an additional sixteen foreign institutions, including six U.S. firms.<sup>353</sup>

In 1988, foreign banks in Japan were told by Japan's Minis-

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<sup>343</sup> Lisa Martineau, *A Long Wait For Foreign Banks*, THE BANKER, January 1987, at 76.

<sup>344</sup> *Id.*

<sup>345</sup> *Id.*

<sup>346</sup> GAO, *supra* note 298, at 20.

<sup>347</sup> *Id.*

<sup>348</sup> *Id.*

<sup>349</sup> *Id.* at 21.

<sup>350</sup> *Id.*

<sup>351</sup> *Id.*

<sup>352</sup> Rosamund, McDougall, *Sitting Tight In Tokyo?*, THE BANKER, Feb. 1989 at 72-73.

<sup>353</sup> *MOF Encouraging Foreign Bank Branch Establishment*, COMLINE DAILY NEWS TOKYO FIN. WIRE, April 19, 1990.

try of Finance that "the establishment of branches by foreign banks in Japan was 'in principle' free of the regulations that apply to branch-establishment by domestic banks."<sup>354</sup> Although domestic banks complained about this policy, foreign banks were pleased. In fact, Citibank planned to open up to fifty branches in the next decade.<sup>355</sup> Moreover, prior to November 1988, foreign banks in Japan were able to obtain funds almost exclusively in the uncollateralized call money market. Consequently, foreign banks were able to make loans to companies on more favorable terms than their Japanese competitors, who were dissuaded by the Bank of Japan from providing interbank loans without collateral. Yet, in the Fall of 1988, the Bank of Japan relaxed its supervision of that market, and Japanese banks gained entry into the call money market. The consequence of this change in policy is that competition in the call money market is greater, because "the margin between the interest rates banks charge their customers and the rates at which banks can borrow" has decreased from .5% to presently .125%.<sup>356</sup> In December 1989, The Tokyo Stock Exchange announced that it would grant membership to three additional foreign companies.<sup>357</sup>

In January 1990, the membership at the Tokyo Stock Exchange was expanded from 114 to 124. The fortunate foreign securities firms—Credit Lyonnais, James Capel, and Barclays de Zoete Wedd—joined the other 22 foreign securities firm members of the Tokyo Stock Exchange.<sup>358</sup> The importance of becoming a full member of the Tokyo Stock Exchange is demonstrated in that foreign firms who have obtained such a designation have profited from the Tokyo Stock Exchange's fixed commissions.<sup>359</sup>

More recently, in February 1991, Japan's Ministry of Finance allowed U.S. securities firms Salomon Brothers, Goldman

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<sup>354</sup> Takahashi, *supra* note 240; JAPAN ECON. J., Aug. 26, 1989, at 2.

<sup>355</sup> *Id.*

<sup>356</sup> *Tokyo Stock Exchange Membership: Friction Expected To Continue*, DAILY NEWS FIN. WIRE, Dec. 19, 1989.

<sup>357</sup> Scott Miller, *U.S. Brokers Win Japan Bank License, Face Tough Currency Fight*, REUTER BUS. REP., Feb. 7, 1991 [hereinafter Miller]; *Pacific Watch*, L.A. TIMES, Feb. 11, 1991, at D3, col. 3 [hereinafter *Pacific Watch*].

<sup>358</sup> *Foreign Securities Firms in Japan: Gilded Seats*, ECONOMIST, Jan. 6, 1990, at 78.

<sup>359</sup> *Id.*

Sachs, and Morgan Stanley to compete as banks.<sup>360</sup> Since trading in non-national currency is primarily limited to banks, the Ministry of Finance granted these U.S. securities firms' European subsidiaries branch status in Japan, thereby enabling these firms to apply for foreign exchange licenses. The foreign exchange licenses of the three securities companies were expected to be granted in March 1991. Prior to this declaration, the three securities companies were limited to conducting foreign exchange transactions only when related to their securities business and to themselves as authorized dealers. Although these three firms can enter a great number of transactions, a Goldman Sachs official in Tokyo noted that his firm will likely focus on foreign exchange and currency options. Nevertheless, this marks another step towards dismantling Article 65 of Japan's Securities and Exchange Law.<sup>361</sup>

Indeed, as noted earlier, foreign financial firms have made some penetration into the Japanese financial industry.<sup>362</sup> In fact, as of June 1991, about 20% of total membership at the TSE—twenty-five securities firms—are foreign.<sup>363</sup> Foreign firms' activities on the TSE comprise, according to Senior Managing Director of the TSE, Mitsuo Sato, "more than 10% of trading."<sup>364</sup>

### VIII. UNITED STATES LEGISLATIVE RESPONSES

The United States attempted to counter the Japanese barriers to foreign banks and securities firms with strong legislative measures.<sup>365</sup> Foremost among such legislation was the Primary Dealer Provision (Provision) in the Omnibus Trade and Competitiveness Act of 1988 (Omnibus Trade Act).<sup>366</sup> Although this

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<sup>360</sup> Miller, *supra* note 358; *Pacific Watch*, *supra* note 358; at D3, col. 3.

<sup>361</sup> *Id.*

<sup>362</sup> "Foreign brokerage houses in Tokyo are doing very well, in light of their short histories and high start-up costs." Harris, *supra* note 77, at 77. Moreover, Mitsuo Sato, Senior Managing Director of the TSE, suggested with a grin, "Salomon Brothers is doing well—maybe too well." *Id.*

<sup>363</sup> *Id.* at 48. Also, the number of foreign firms listed on the Tokyo Stock Exchange has more than doubled over the past five years, currently reaching the figure of 125. *Id.*

<sup>364</sup> *Id.*

<sup>365</sup> See *infra* notes 367-391 and accompanying text.

<sup>366</sup> 19 U.S.C. § 2901 (1988) [hereinafter OTCA of 1988]; Mark A. Pearson, *Using Legislation To Open Japan's Financial Markets: An Analysis of the Trade Bill's Primary Dealer Provision*, 1989 B.Y.U. L. REV. 579 [hereinafter Pearson].

provision does not require Japan or any other nation to liberalize its market access, legislative history provides that Japanese discriminatory practices were considered.<sup>367</sup>

The United States government has long asserted that Japan's financial and securities markets contain barriers that limit access by U.S. firms.<sup>368</sup> The U.S. proffered that extensive liberalization is needed, particularly in the sale of Japanese government bonds.<sup>369</sup> The barriers in the Japanese bond market, as viewed by the United States, are essentially two-pronged: limited access to the bond market and the syndication of bonds.<sup>370</sup>

Limited foreign participation in the Japanese government bond market, while on the increase, is relegated to an insignificant figure.<sup>371</sup> The marginal participation of foreign firms in this area follows 1987 Japanese legislation permitting an auction on twenty-year government bond issues and a limited auction on one-fifth of a distinct ten-year government bond issue.<sup>372</sup>

Procedures for the sale of Japanese government bonds have posed difficulties for the United States. While the United States government sells bonds to the highest bidder in an open market auction, the Japanese government uses a syndication system. Under this method the Ministry of Finance determines in detail the scope of the sale.<sup>373</sup>

The reasoning for the Japanese approach in the sale of these bonds is several-fold. First, it allows the Japanese central bank to maintain greater control over interest rates.<sup>374</sup> If foreign firms were allowed to compete, the domestic control would be threatened. Second, it provides the Japanese firms with a substantial share of the bond market, giving these firms a strong niche in the Japanese market.<sup>375</sup> Third, "if initial issuance of

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<sup>367</sup> Pearson, *supra* note 366, at 579.

<sup>368</sup> GAO, *supra* note 298, at 15-16.

<sup>369</sup> *Id.* at 16.

<sup>370</sup> *Id.* at 15-16; see also Lyal Haughton, *A Fair Slice of Pie Depends On The Point of View*, *EUROMONEY*, Mar. 1987, at 126 [hereinafter Haughton].

<sup>371</sup> GAO, *supra* note 298, at 15.

<sup>372</sup> *Id.*

<sup>373</sup> *Houses Find Treasury Bond System Archaic*, *EUROMONEY*, Supp., Apr. 1987, at 85; Pearson, *supra* note 367, at 584.

<sup>374</sup> Pearson, *supra* note 366, at 585.

<sup>375</sup> Michael R. Sesit & Herman, *Japanese Firms Make Controversial Bid: The U.S. Government Bond Market*, *WALL ST. J.*, Jan. 7, 1987, at 32, col. 1 [hereinafter Sesit &

bonds [were] done by auction, new maturities [would] cost more because the Ministry of Finance might be forced to raise interest rates in order to attract buyers."<sup>376</sup>

While the use of the Primary Dealer Provision was supported by some in Congress, several segments of the United States government and industry opposed it.<sup>377</sup> More specifically, E. Gerald Corrigan, President of the Federal Reserve of New York, explained that this provision was the wrong way to liberalize Japan's financial system because it would likely anger Japan.<sup>378</sup> Moreover, Mr. Corrigan noted that the provision would produce "adverse side effects — both in terms of general attitude toward market liberalization and capital inflows to the U.S."<sup>379</sup> Second, U.S. Treasury Secretary James Baker argued that the United States had already made some advances in bilateral discussions. In his view, further dialogue, rather than this legislation, would assist U.S. financial institutions and maintain foreign investment in the United States.<sup>380</sup> Third, a U.S. banking industry representative, although acknowledging the benefits of using tough legislation, argued that the United States should continue utilizing the negotiation process.<sup>381</sup>

In contrast, adherents to the strict components of the provision argued that the legislation was the best method for getting Japan's attention.<sup>382</sup> It has been suggested that Japan's movement to accelerate the opening of its markets was prompted by the preliminary drafts of the Provision.<sup>383</sup> As the legislation progressed in Congress, increased liberalization became apparent.<sup>384</sup>

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Herman]; Pearson, *supra* note 367, at 586.

<sup>376</sup> Haughton, *supra* note 371, at 128; Pearson, *supra* note 367, at 585.

<sup>377</sup> Sesit, *supra* note 376.

<sup>378</sup> Pearson, *supra* note 366, at 587.

<sup>379</sup> *Id.*, citing *United States Access to Japanese Financial Markets, 1987: Hearing Before the Comm. on the Budget, United States Senate, 100th Cong., 1st Sess., 52-54 (1987) (Appendix III to the testimony of E. Gerald Corrigan, Pres., Fed. Reserve Bank of New York).*

<sup>380</sup> Pearson, *supra* note 366, at 588.

<sup>381</sup> *Id.* at 587.

<sup>382</sup> Michael R. Sesit, *U.S. To Press Nakasone For More Access In Japan For American Financial Firms*, WALL ST. J., Apr. 27, 1987, at 21, col. 3, cited in Pearson, *supra* note 367, at 589.

<sup>383</sup> Pearson, *supra* note 367, at 589.

<sup>384</sup> *Id.* at 590-91.

More recently, in May 1990, the Japan-United States working group on financial markets held its second session.<sup>385</sup> The United States representative, Treasury Undersecretary David Mulford, stated that the United States was pleased with recent Japanese liberalization in certain areas, including overseas bank accounts.<sup>386</sup> However, the United States government was troubled by restrictions on bank deposit rates and foreign firms' access to the Japanese money market.<sup>387</sup>

Now United States Congressional pressure on Japan, aimed at speeding up financial deregulation, includes a proposed Fair Trade in Financial Services Act.<sup>388</sup> This proposed legislation was passed by the Senate and is being considered by the United States House of Representatives.<sup>389</sup> It would permit the Federal Reserve Board to "disapprove expansion of U.S. operations by foreign financial institutions if the Treasury Secretary judges that their countries fail to give U.S. institutions opportunities to fairly compete in their domestic markets."<sup>390</sup> Such legislation will pressure Japan to provide foreign financial institutions national treatment. In doing so, foreign financial institutions, such as American banks, will be better able to compete with Japanese banks in the lucrative Japanese market.

## IX. CONCLUSION

Japan's regulatory structure regarding domestic and foreign financial institutions has experienced steady and significant changes. While this liberalization is necessary to integrate global financial markets in general, and the Japanese system in particular, the elimination of other barriers would facilitate a step towards further harmonization of financial regulations world-wide. Ultimately, the concepts of national treatment and reciprocity will merge when applied to the regulation of financial institutions. Foreign banks will be treated in the same manner as domestic banks (national treatment), and the activities that a for-

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<sup>385</sup> Masaharu Usuki, *Tokyo Economist Says Japan Should Speed Deregulation*, AM. BANKER, August 24, 1990, at 4 [hereinafter Usuki].

<sup>386</sup> *Id.*

<sup>387</sup> *Id.*

<sup>388</sup> *Id.*

<sup>389</sup> *Tokyo Getting Tough*, *supra* note 284, at 110.

<sup>390</sup> Usuki, *supra* note 386, at 4.



eign financial institution will be allowed to carry out in Japan will be determined by the treatment Japanese banks are given in a foreign country, such as the United States (reciprocity). Since large strides in harmonization should lead to unity in law, host and home countries' laws will be equivalent. Yet, due to varying degrees of development, many other economic matters and significant political problems, such as a regulatory scheme for financial institutions, are many years away.