
Brian Arthur Pomper

Follow this and additional works at: http://scholarship.law.cornell.edu/cilj

Part of the Law Commons

Recommended Citation
Available at: http://scholarship.law.cornell.edu/cilj/vol28/iss2/9

Brian Arthur Pomper *

Introduction

On April 1 of 1993, the Japanese National Diet¹ implemented a wide-ranging set of reforms to the Japanese financial system² that it had adopted as the Financial System Reform Law³ almost one year earlier.⁴ Various arms of the powerful Ministry of Finance (MOF)⁵ had been work-

¹ After Japan’s surrender to the Allied Forces in 1945, the Japanese legal system was restructured primarily on an American model. Hideo Tanaka, Impact of Foreign Law in Japan: American Law, in THE JAPANESE LEGAL SYSTEM 245, 249 (Hideo Tanaka ed., 1976). The Japanese National Diet, commonly referred to as “the Diet,” is both the structural and functional counterpart to the United States Congress. It is a bicameral legislature composed of popularly elected officials entrusted with the primary lawmaking power in Japan. THE JAPANESE LEGAL SYSTEM, supra, at 37-38. See also JAPAN CONST. arts. 41-64 (explaining the structure and powers of the Diet).


⁵ The MOF is an extremely powerful regulatory body that has the primary responsibility for regulating the Japanese financial system. The Minister of Finance, a cabinet official appointed by the Prime Minister, heads the MOF. Its powers are much broader than any single U.S. regulatory authority, regulating substantially all private and public financial institutions. In essence, the MOF combines the regulatory functions of the United States Treasury, Office of Management and Budget, Internal Revenue Service, Securities and Exchange Commission, Comptroller of the Currency, and all the state banking and insurance agencies, as well as the supervisory functions of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision. MAUREEN LEBLANC & ANDREW C. SVARRE, THE JAPANESE FINANCIAL SYSTEM 2 (1988). Many consider the MOF to be Japan’s most powerful institution. Larry Hol- yoke, Firestorm Around the Fortress, Bus. Wk., Mar. 7, 1994, at 58.

Advisory councils are standing or ad hoc committees attached to the Japanese ministries whose purpose is to research and debate issues referred to them. The councils are composed of academics, industry leaders, journalists, and members of other groups who have a stake in the various issues being discussed. The councils report their con-
ing on the reforms since 1985, focusing on fostering competition by liberalizing Japan's highly specialized financial system. The old policy of limiting competition to protect banks worked well when Japan was a developing nation and experiencing dramatic financial growth, but fundamental changes in the structure of the Japanese economy showed that reform was needed. Concurrent with these domestic structural changes, the increasing globalization and internationalization of world economies in general, and the Japanese economy in particular, led to calls for the liberalization of Japan's money markets that rose to a fever-pitch by the mid-1980's.

In response to these pressures, the main thrust of the reform was to promote the efficient use of resources by increasing competition within the Japanese financial system. However, after a series of scandals erupted in the securities industry in June 1991 and in the banking indu-

---

6. FINANCIAL SYSTEM RESEARCH COUNCIL, ON A NEW JAPANESE FINANCIAL SYSTEM 10 (Federation of Bankers Association of Japan trans., June 25, 1991) [hereinafter RESEARCH COUNCIL REPORT].
9. For instance, an extraordinarily high level of financial assets has been accumulated, supported in part by Japan's perennially high savings rate, leading to excess liquidity. Colin P.A. Jones, Note, Japanese Banking Reform: A Legal Analysis of Recent Developments, 3 DUKE J. COMP. & INT'L L. 387, 406-07 (1993). This situation stands in marked contrast to the circumstances under which the financial system had been organized after the war, when capital-starved industries desperately needed additional funds to promote growth. RESEARCH COUNCIL REPORT, supra note 6, at 9. The accumulation of financial assets has led to a demand for more convenient and profitable financial products and services, and technological advances have enhanced the feasibility of providing them. Id.
10. THE BANKING SYSTEM, supra note 8, at 3.
11. The Hiraiwa Committee, the government's advisory group for economic reform, recently emphasized the need to increase competition in the Japanese financial system by relaxing regulations separating the various sectors of the Japanese economy. Two-Way Openings, THE BANKER, Jan. 1994, at 52. See also RESEARCH COUNCIL REPORT, supra note 6, at 9.
try shortly thereafter, the Finance Ministry also began seeking methods to restore flagging confidence in Japanese financial institutions. As a result, the reform includes strengthened provisions on business information disclosure, capital adequacy requirements, and measures to promote competition.

The MOF had three main objectives in drafting the new law. First, it sought to diversify the activities of each bank within Japan’s highly specialized banking industry in order to allow competition and thereby promote efficiency. Second, the MOF took measures to encourage sound management of financial institutions in several ways, including allowing financial managers increased independence from the paternalistic guidance of the MOF, reinforecing the disclosure system, and creating provisions regulating the adequacy of capitalization. Third, and most importantly, the MOF relaxed the boundary between the banking and securities industries by allowing each to have a subsidiary competing in the other’s market, with the hope that this would promote the development of new and innovative financial products and services.

This last provision is the centerpiece of the new reform. Liberalization of financial markets and market innovation in both Japan and the

of the so-called “Big Four” securities houses, Daiwa Securities Co., Ltd. and Yamaichi Securities Co., Ltd. also admitted to improper compensation payments. See C. Jeffrey Char, Reforming Japan’s Securities Markets: The Loss Compensation Scandal, 10 INT’L TAX & BUS. LAW. 175, 177 (1993). Such a guarantee is harmful to the market because it removes corporations’ incentive to invest wisely in worthwhile stocks, since they no longer have to worry about losing money. This practice not only wastes useful capital on speculative, unproductive stock, but also keeps that capital from being invested to support worthwhile ventures. Id. at 178. The law has since been amended to forbid the payment of compensation as well as promises to pay. Shoken Torihikiho [Securities and Exchange Law], Law No. 25 of 1948 (as amended), art. 50-2 (hereinafter SEL) (copy on file with the Cornell International Law Journal). See also Char, supra, at 194; Oba, supra note 5, at 315. For a thorough description and analysis of the scandals, see Char, supra; David A. Sneider, Recent Developments in Japan’s Securities Markets, in INTERNATIONAL SECURITIES MARKETS 1993, at 345, 394-409 (PLI Corp. Law and Practice Course Handbook Series No. 798, 1993).


15. RESEARCH COUNCIL REPORT, supra note 6, at 27.
16. Id. at 12-14.
17. See Two-Way Openings, supra note 11, at 53.
18. RESEARCH COUNCIL REPORT, supra note 6, at 27.
19. Id. at 20-22. See also Isaka, supra note 7, at 3 (“At a press conference after the cabinet approved the bills, Finance Minister Tsutomu Hata said that ‘the main aim of the reform is to foster competition by lowering barriers separating different types of financial institutions, while ensuring soundness of their management.’”).
20. Isaka, supra note 7, at 3
United States has put banks at a competitive disadvantage vis-à-vis non-bank financial institutions in both the deposit and loan markets. This is a natural phenomenon when increasingly sophisticated investors with growing sums of excess capital close their bank accounts to seek higher interest-bearing opportunities. As a result, bank profits and capital have declined, and banks have been unable to respond to these competitive pressures because of restrictions on the range of permissible bank activities. More specifically, Article 65 of the Japanese Securities and Exchange Law imposes a strict separation between banking and securities activities similar to that imposed by the Glass-Steagall Act in America. As profits waned, Japanese bankers increased pressure on the MOF to repeal the Article 65 restriction and allow them access to Japanese capital markets. The Financial System Reform Law responds to the bankers' concerns by allowing mutual entry between the banking and securities industries through the use of wholly-owned but functionally separate subsidiaries. In this respect, the reform is almost revolutionary and represents a significant step toward abolishing the wall that has prevented banks

21. Thomas F. Cargill & Gregory F.W. Todd, Japan's Financial System Reform Law: Progress Toward Financial Liberalization?, 19 BROOK. J. INT'L L. 47, 47 (1993). See RESEARCH COUNCIL REPORT, supra note 6, at 12 (“In recent years, the fund raising of large and medium-size corporations has shifted from bank loans to the issue of securities.”).

22. The postal savings system in Japan provides one example. The Japanese Postal Savings Bureau, at one time the largest deposit-taking organization in the world, was originally established in 1875 to promote small-volume personal savings and channel resulting funds into industrial development and modernization. DEREK F. CHANNON, GLOBAL BANKING STRATEGY 270-71 (1988). The postal savings system has evolved to include services that banks cannot provide, including interest rates that increase with the term of the deposit, putting the system in competition with private financial institutions. THE BANKING SYSTEM, supra note 8, at 35. With this progressive interest rate and increased service, these accounts are more attractive to depositors than ordinary bank savings accounts. Indeed, in the period from January to July, 1991, over four trillion yen was transferred from banks to post office accounts, giving rise to fears that this trend would upset the entire financial system. See Hayato Yokota, Massive Money Shift Alarms Banks, NIKKEI WKLY., Nov. 9, 1991, at 1; Clear Vision Sought for Financial Reforms, Jiji Press Ticker Service, Feb. 23, 1994, available in LEXIS, News Library, CURNWS File. See also Cargill & Todd, supra note 21, at 47-48

(During the 1980s Japanese borrowers became increasingly able to access the Euromarkets for long-term funding, while the Japanese pension funds and insurance companies, with ever larger reservoirs of funds to be invested in portfolio securities, were ready purchasers of such borrowers' securities. Borrowers found lower cost funding than that available within Japan, cutting the banks out in the process.)

23. Cargill & Todd, supra note 21, at 47-48.


25. See infra part II.B.

26. See infra part II.A.


28. The Japanese adopted this structure to avoid harmful conflicts of interest between banking and securities concerns. RESEARCH COUNCIL REPORT, supra note 6, at 21. Although it is not the only solution, the Financial System Research Council and the Securities and Exchange Council agree in their respective reports that it is the best solution among the alternatives. Id.; HOW BASIC SYSTEM REGARDING CAPITAL MARKET
from dealing in capital markets for over forty-five years.\textsuperscript{30}

This Note will examine various aspects of the Financial System Reform Law, focusing on the easing of Article 65 restrictions and the separated securities subsidiaries that have been and will be established under the law.\textsuperscript{31} Part I will give an overview of the Japanese financial system as it existed before the reforms, tracking its history and evolution. Part II will discuss the separation of commercial and investment banking in both America and Japan, examining the historical reasons for the separation and assessing their continued viability. Part III will critique the Japanese banking reform and assess its likelihood of success in promoting efficiency and creating new financial products and services by comparing the reformed Japanese financial system with that of the United States, widely thought to be the most creative and innovative financial system in the world.\textsuperscript{32} The Note concludes that the manner in which the Japanese reformers are implementing the changes is likely to dampen any increased competitive pressure and lower the incentive to innovate.

I. The Japanese Financial System Before the Reform

A. The History of Japanese Banking

The Meiji Restoration of 1868 transformed Japan from a primitive feudal society led by the chief warlord, or Shogun, into a modern capitalist nation.\textsuperscript{33} At that time, the memory of Commodore Perry remained fresh in Japanese minds and provided a strong incentive for Japan to industrialize and catch up with the Western world.\textsuperscript{34} Faced with the humiliating
prospect of subjugation by these more powerful nations, Japan began to modernize its political and social systems rapidly, relying heavily on foreign legal models and using law as a tool of social engineering.

The Japanese laid the foundations of their current banking and securities systems during this period. Based on an American model, the National Bank Act of 1872 ushered in the modern era of banking in Japan. The first securities legislation, however, the Stock Transaction Ordinance of 1874, was modeled after the London Stock Exchange rules. The Japanese established their first stock exchanges at Tokyo and Osaka in 1878, but these were speculative and lacked a true capital market function. Consequently, the banks, not the securities markets, financed Japan’s rapid industrialization during this period.

From the period of modernization until the end of World War II, the banking industry evolved into a specialized system in which financial institutions served only limited sectors of the economy rather than providing comprehensive service. Financial institutions were classified as either short-term or long-term institutions, a distinction that still holds significance today. From the period of modernization to the present, ordinary banks have been the primary source of short-term commercial loans. During the same period, long-term financing banks, classified as “special banks,” were protected and regulated by the government to channel long-term financing to the sectors finance was needed.

was so impressed with the American show of power that he agreed to commence trade with America when Perry returned to Japan in February of 1854, ending nearly 200 years of self-imposed Japanese isolation. Id. See Yosiyuki Noda, Comparative Jurisprudence in Japan: Its Past and Present, in THE JAPANESE LEGAL SYSTEM, supra note 1, at 199 (“[W]hen [Japan] awoke from its dream world of almost two hundred years of isolation and opened its doors to outside contact, imperialistically-inspired Western powers were right on the doorstep.”). Id. See also Oda, supra note 5, at 10. Perhaps the threat of foreign domination provides an explanation for the slogan of the rapid Japanese industrialization process during the late 19th century: “Enrich the country and strengthen the army.” Id. at 31. The Banking System, supra note 8, at 11. Japan’s first bank, the First National Bank, was founded in Tokyo in 1873. Id. This bank underwent several transformations over many decades, merging with the Nippon Kangyo Bank before becoming the present-day Dai-Ichi Kangyo Bank. Id. at 36. Makota Yazawa, A Synopsis of Securities Regulation in Japan, in JAPANESE SECURITIES REGULATION 23, 26-27 (Louis Loss et al. eds., 1983). Cargill & Todd, supra note 21, at 51 n.9. Oda, supra note 5, at 298. In fact, non-bank financial institutions and securities markets historically played a relatively minor role in Japan. Cargill & Todd, supra note 21, at 51. Between 1965 and 1974, nearly 80% of corporate financing was in the form of bank loans. YOSHI SUZUKI, THE JAPANESE FINANCIAL SYSTEM 14-16 (1989). From 1975 to 1984, the degree of bank borrowing as a percentage of total corporate finance fell to 60% as borrowers turned increasingly to equity finance, in part resulting from the large scale issuance of government bonds in 1975. Id. Jones, supra note 9, at 389. The Banking System, supra note 8, at 13. The difference between these two types of banks is simple but fundamental: long-term banks are permitted to raise long-term funds by issuing long-term securities, such as bank debentures with five-year maturities, but short-term banks are limited to a two-year limit on time deposits, their main source of funding. Id. See also Suzuki, supra note 40, at 96. The Banking System, supra note 8, at 13. Other sources of short-term loans include sogo banks and shinkin banks. See infra notes 65-66 and accompanying text.
term funds into industry and agriculture.\textsuperscript{44} The Trust Law and Trust Business Law of 1922 established the trust business\textsuperscript{45} as a financial industry distinct and separate from the banking industry, in which only trust companies and trust banks could engage.\textsuperscript{46}

B. Financial Institutions in Postwar Japan

The Allied occupation of Japan after World War II brought with it many significant changes to the Japanese financial system.\textsuperscript{47} In an effort to allocate scarce funds to capital-starved, fledgling industries quickly during post-war reconstruction, Japan reorganized its existing financial system into a complicated system of small banks specializing in different areas of the economy.\textsuperscript{48} This system ensured a stable supply of funds for each industrial sector and helped rebuild the war-torn Japanese economy during occupation.\textsuperscript{49} In addition, this system of separation and specialization helped nurture financial institutions by protecting them from competition.

\begin{itemize}
  \item \textsuperscript{44} \textbf{THE BANKING SYSTEM, supra note 8}, at 13. For example, the government established the Nippon Kangyo Bank in 1896 to promote industrial and agricultural modernization by supplying long-term loans. \textit{Id.} The special bank system was abolished after World War II. \textit{Id.} at 14.
  \item \textsuperscript{45} The trust business originally began as a business which involved managing another person’s assets for a specified purpose:
    \begin{quote}
      The trust business is a set of transactions in which a trust owner transfers, through a set of legal acts (act of trust), the property rights of his own property to another party (the trustee) and at the same time entrusts the management and disposal of these assets to the trustee for a specified purpose (the purpose of the trust) for the benefit of society, himself, or a third party (the beneficiary). In such cases, the trustee receives a transfer of assets and has the right to manage and dispose of these assets for the specified purpose in his own name and not in the name of the trust owner.
    \end{quote}
    \textbf{SuzuKI, supra note 40, at 206.} Today the trust banks are most important as providers of long-term finance. \textit{Id.} at 207.
  \item \textsuperscript{46} \textbf{THE BANKING SYSTEM, supra note 8}, at 15. These businesses were separated because of concern regarding conflicts of interest. \textbf{SUZUKI, supra note 40, at 38.} A 1943 law eliminated the distinction between trust banks and ordinary banks, but the MOF again separated the banking and trust businesses after the war. \textbf{THE BANKING SYSTEM, supra note 8}, at 15. Although the same institution can engage in both the banking and trust businesses, they must be managed separately. \textbf{SUZUKI, supra note 40, at 207.} Consequently, trust banks have two sets of accounts, one for banking accounts and the other for trust accounts. The banking accounts cover short-term finance while the trust accounts focus on supplying funds for capital investment. \textbf{SUZUKI, supra note 40, at 207; THE BANKING SYSTEM, supra note 8, at 25.} \textit{See generally SUZUKI, supra note 40, at 206-15.}
  \item \textsuperscript{47} \textbf{Jones, supra note 9, at 390.}
  \item \textsuperscript{48} \textbf{RESEARCH COUNCIL REPORT, supra note 6, at 9; Cargill & Todd, supra note 21, at 51 (“Banks, including various specialized financial institutions, were established to mobilize the country’s financial resources in support of industrialization and economic growth.”).}
  \item \textsuperscript{49} The Research Council explained the restructuring of the Japanese financial system after World War II in its report to the MOF as follows:
    \begin{quote}
      The existing financial system was basically organized for the purpose of creating a stable supply of limited funds for each industrial sector in the post-war era when funds were short. This financial system supported the post-war economic recovery and the subsequent high economic growth, making a major contribution to the economic development of Japan.
    \end{quote}
\end{itemize}
with one another and foreign banks. In this vein, the post-war Japanese government separated the securities business from the business of banking by imposing restrictions on permissible banking activities similar to those contained in the Glass-Steagall Act in the United States. Specifically, banks were prohibited from engaging in any transactions involving the buying, selling, underwriting, brokering, issuance, or public offering of equity securities. By making the securities business the strict province of securities firms, the government sought to nurture and develop the Japanese securities industry and protect it from the economic might traditionally wielded by the Japanese banks.

The current Japanese financial system is still characterized by specialization and separation. Almost all of Japan’s financial institutions can be classified into seven main categories according to their primary business activity: 1) commercial banks which focus on providing short-term

---

RESEARCH COUNCIL REPORT, supra note 6, at 12.

50. Id.


52. See infra part II.A. Before World War II, banks could and did act as major underwriters of public and corporate bonds but left the riskier securities transactions to the securities companies. ODA, supra note 5, at 302-03; THE BANKING SYSTEM, supra note 8, at 16; SUZUKI, supra note 40, at 39.

53. SEL, supra note 12, at 65.


55. RESEARCH COUNCIL REPORT, supra note 6, at 9; THE BANKING SYSTEM, supra note 8, at 11. The separation of the banking industry according to the type of patron served is more historical than functional at this point. SUZUKI, supra note 40, at 168. The ordinary banks were born first, engaging in the full range of traditional banking activities, and they were followed later by special financial institutions created to service various sectors of industry and facilitate Japanese industrialization and modernization. Id. After this, institutions for small businesses and for trust businesses arose to address the needs of those sectors. Id.

56. SUZUKI, supra note 40, at 163. Only the Bank of Japan is left out of this classification scheme. Established in 1882 as the country’s central bank, it is Japan’s only issuing bank. The Bank of Japan is a special corporation that is neither wholly private nor a governmental entity although it is entrusted with important public duties. It fulfills a role not unlike that of the Federal Reserve System and Federal Reserve Board in the United States: it issues bank notes, acts as a bank for other banks and for the government, controls credit, and implements monetary policy through adjustments in the official discount rate and the reserve deposit requirement and by engaging in open market transactions. See THE BANKING SYSTEM, supra note 8, at 20-22; see also FREDERIC S. MISHKIN, THE ECONOMICS OF MONEY, BANKING, AND FINANCIAL MARKETS 388-96 (3d ed. 1992) (describing the operation of the United States Federal Reserve System).

57. The newly amended Banking Law defines “bank” as any entity duly licensed by the Minister of Finance to carry on the business of banking, including accepting deposits, lending money, and engaging in exchange transactions. Banking Law, Law No. 59 of 1981 (as amended), art. 2 [hereinafter Banking Law] (unofficial translation on file with the Cornell International Law Journal).
finance, also called ordinary banks, including city banks, regional banks, and foreign banks operating in Japan; 2) financial institutions that provide long-term credit for the industrial sector, including long-term credit banks and trust banks; 3) specialized foreign exchange banks that serve the needs of foreign exchange and trade finance, a narrow category limited to the Bank of Tokyo; 4) financial institutions that loan primarily to small businesses, such as sogo banks, shinkin banks and the Zenshinren Bank, credit cooperatives, labor credit associations and the
Rokinren Bank, and the Shokochukin Bank; 69 5) financial institutions that concentrate on financing private sector agriculture, forestry, and fishery activities, including such organizations as agricultural cooperatives, 70 fishery cooperatives, and the Norinchukin Bank; 72 6) securities companies that operate in the securities markets, dealing in capital market and equity financing; 75 and 7) governmental financial organizations that enhance local residents and small to medium-sized area businesses with no more than 300 employees and a maximum capitalization of ¥400 million. The Banking System, supra note 8, at 26. The Shinkin Bank Law established the Zenshinren Bank as the central institution for shinkin banks, giving it the responsibility of coordinating fund concentration within the shinkin bank system, improving investment efficiency, being a payment intermediary for payments of public utilities and other debts, and providing low-interest loans as a type of deposit insurance for shinkin banks in financial difficulty during local crises to ensure solvency, among other responsibilities. Suzuki, supra note 40, at 223-24. See generally id. at 218-24.

67. Credit cooperatives are cooperative financial institutions founded for the mutual benefit of their members, small and medium-sized businesses and their employees, and are regulated by the prefectural governors. Suzuki, supra note 40, at 225; The Banking System, supra note 8, at 27. These organizations primarily accept deposits from, and give loans to, members although they can loan money to non-members who have a deposit account. Id. See generally Suzuki, supra note 40, at 225-28.

68. Labor credit associations, or labor banks, are cooperative financial institutions which provide financial services to increase local laborers' standards of living primarily by accepting deposits from and loaning funds to members. The Banking System, supra note 8, at 27. They encourage the welfare activities of labor unions, consumer cooperatives, and other organizations that promote the interests of labor. Id. The Rokinren Bank, also known as the National Federation of Labor Credit Associations, is the central organization for labor banks around the country, much as the Zenshinren Bank is to the shinkin banks. It also serves a similar coordinating role, strengthening the mutual support base of the labor banks. Id. at 28.

69. Organized under the Shokochukin Bank Law of 1936, the Shokochukin Bank is a special corporation that provides financial services and assistance to the cooperative societies of small to medium-sized companies. Suzuki, supra note 40, at 230. Although it is a private corporation, the government participates in many of its activities. The Banking System, supra note 8, at 28. See generally Suzuki, supra note 40, at 230-31.

70. Agricultural cooperatives take deposits from, and loan funds to, their members, mostly farmers, to promote the local farming base and living environment. The Banking System, supra note 8, at 29. They are unique among financial institutions in that they are run by their members and actively participate in other businesses, including marketing agricultural produce and purchasing equipment and materials for farming. Id. See generally Suzuki, supra note 40, at 235-38.

71. Fishery cooperatives serve the fishing industry and engage in the same credit activities as agricultural cooperatives, taking deposits from, and lending to, members but on a much smaller scale. See The Banking System, supra note 8, at 30. See generally Suzuki, supra note 40, at 238.

72. The government established the Norinchukin Bank in 1923 to serve as the central financial institution for cooperatives in the agricultural, forestry, and fishery industries. The Banking System, supra note 8, at 30. The bank plays a crucial role in financing these industries; they usually cannot obtain financing from other sources because of their weak collateral endowments, low profitability, and long-term or seasonal demand for funds. Suzuki, supra note 40, at 232. The Norinchukin Bank lends its funds almost exclusively to the cooperatives and to other individuals and enterprises either employed in or in some way connected with the agricultural, forestry, or fishery industries. Id. at 233. See generally id. at 232-35.

73. The Securities and Exchange Law defines the securities business as follows:
the functioning of private financial intermediaries\textsuperscript{74} such as the Japan Development Bank and the Export-Import Bank of Japan.\textsuperscript{76} Despite changes in the structure and needs of the Japanese economy, this highly rigid compartmentalization of financial business activities endured until 1993 and still persists in some manifestations today.\textsuperscript{76} Today, the MOF views the system as unnecessarily protectionist and likely to hinder the efficient distribution of funds.\textsuperscript{77} The Diet passed the Financial System Reform Law to encourage competition between the various sectors of the financial system in the hope that competition would promote the efficient use of capital, spark the creation of innovative financial products, and help banks develop services to serve consumers better.\textsuperscript{78}

II. The Separation of the Banking and Securities Industries

As countries that legally require the separation between their banking and

\textit{a business doing any of the following acts by any person other than banks, trust
companies, and such other financial institutions as may be prescribed by a Cabinet order.}

(1) To buy and sell securities or trade in futures of securities index, etc., securities options, or securities futures of foreign markets,
(2) to act as broker, agent or proxy with respect to buying and selling of securities or trading in securities options or securities futures of foreign markets,
(3) to act as broker, agent or proxy with respect to orders for trades below specified:
   a) buying or selling of securities, or trading in futures of securities index, etc., or securities options, or
   b) buying or selling of securities or trading in securities futures of foreign markets on foreign securities markets (this refers to markets located in foreign countries which are similar to the securities markets; the same shall apply hereinafter),
(4) to underwrite securities,
(5) to sell securities through public offering, or
(6) to handle the issuance or the sale of securities through public offering, or to handle solicitations for an offer to acquire a security to be issued anew which do not fall within the purview of public offering of a security (hereinafter referred to as “private placement”).

\textit{SEL, supra note 12, art. 2, para. 8. A securities company is any company that has
received a license from the MOF to engage in the securities business. \textit{Id.} para. 9. See \textit{generally Suzuki, supra note 40, at 260-69. For the last 45 years, Article 65 of the Securities and Exchange Law has kept the securities and banking industries separate. See infra part II.B.}

\textit{74. These governmental institutions provide an additional source of long-term funds to aid in the continued industrial development and general economic development of society. See \textit{generally Suzuki, supra note 40, at 287-96.}

\textit{75. \textit{Id.} at 287.}

\textit{Far from being short of funds today, the Japanese economy has a surplus and does not need to allocate funds through a stable distribution to key industries. \textit{Id.} Yet, strict controls on functional segmentation of the financial system remain. \textit{Id.} at 35. Few countries enforce the triple segmentation among private financial institutions that persists in Japan: the segmentation among short-term and long-term finance, deposit banking and the trust business, and the banking and securities business. \textit{Id.} at 36.}

\textit{77. \textit{Research Council Report, supra note 6, at 12; The Banking System, supra note 8, at 6.}

\textit{78. \textit{Research Council Report, supra note 6, at 12.}
securities industries, the United States and Japan stand virtually alone. In the United States, the Glass-Steagall Act stands as a barrier separating banking from securities activities, but the barrier is not impenetrable, and it has weakened significantly in recent years through regulatory action and legislative interpretation. In Japan, Article 65 of the Securities and Exchange Law of 1948 serves a similar function, but unlike its American counterpart, it has been strictly observed since its enactment at the end of World War II. Although the Japanese prohibition was modeled after the U.S. statute, wholly different concerns motivated the two provisions. The different goals sought to be achieved by the Americans and the Japanese help explain important differences in their respective laws. This section will discuss the history and philosophy of both the Glass-Steagall Act and Article 65 and describe their operation in present-day America and Japan.

A. The Glass-Steagall Act in the United States

1. History of the Glass-Steagall Act

The Glass-Steagall Act separates the banking business from the securities business in America by preventing bankers from acting as underwriters, brokers, and market makers, sometimes even acting as the dominant force in these securities activities in their domestic markets. Donald E. McNees, Global Financial Market Structure: Implications of Regulations for Competitiveness, Issues in Bank Regulation, Fall 1990, at 2, 4; George J. Benston, The Separation of Commercial and Investment Banking: The Glass-Steagall Act Revisited and Reconsidered 2 (1990).


81. See infra part II.A.3.

82. Article 65, entitled "Prohibition of Securities Business by Financial Institutions," provides that

[n]o bank, trust company and such other financial institutions as may be prescribed by the Ministry of Finance shall do as its business any of the acts set forth in the items of Paragraph 8 of Article 2 [supra, note 69 (acts that define a company as a securities business)]; Provided, That this shall not apply to cases where any bank buys or sells securities or effects securities index futures trading, securities options trading or foreign market's securities index futures trading pursuant to a written order received from its customer for the account of such customer or where any bank, trust company or such other financial institutions as may be prescribed by a Cabinet Order buys or sells securities or effects securities index futures trading, securities options trading or foreign market's securities futures trading for the purpose of investment or pursuant to a trust agreement signed with its customers and for the account of such customers in accordance with the provisions of other laws.

SEL, supra note 12, at 65.


84. Sections 16 and 21 are the provisions that require the separation between banking and securities activities. Section 16 directs that

the business of dealing in securities and stock by [a bank] shall be limited to purchasing and selling such securities and stock without recourse, solely upon
of securities and investment bankers from accepting deposits.\textsuperscript{85} Prior to the passage of the Act, the prevailing attitude was that, while inappropriate for commercial bankers to enter the securities market directly,\textsuperscript{86} it was perfectly ethical for them to establish business affiliates that handled securities.\textsuperscript{87} In this way, bankers were able to deal in securities and participate in the investment banking business consistent with the socially established norm. By 1930, the commercial banks were the acknowledged industry leaders, accounting for 44.6\% of all new issues.\textsuperscript{88}

The commercial banks’ primacy in investment banking activities was not to last forever. The stock market crashed in October of 1929,\textsuperscript{89} and the Great Depression followed. Public confidence in the banking system virtually disappeared, and people withdrew their money in droves.\textsuperscript{90} By 1933, over forty percent of the nation’s banks had failed or were forced to merge, reducing the number of banks in the United States from 25,000 to 14,000.\textsuperscript{91} Congressional investigations uncovered evidence that commercial bankers, in connection with their investment banking activities, committed many unethical and irresponsible acts, including forcing their banking customers to buy unmarketable securities the banks had underwritten.\textsuperscript{92} Congress believed that commercial bank involvement in speculative investments had helped cause and aggravate the stock market decline.\textsuperscript{93}

---

the order, and for the account of, customers, and in no case for its own account, and the [bank] shall not underwrite any issue of securities or stock... Banking Act of 1933, ch. 89, § 16, 48 Stat. 162 (codified as amended at 12 U.S.C. § 24, Seventh (1988)). The statute further provides that it shall be unlawful... for any person, firm, corporation, association, business trust, or other similar organization, engaged in the business of issuing, underwriting, selling, or distributing... stocks, bonds, debentures, notes, or other securities, to engage at the same time to any extent whatever in the business of receiving deposits subject to check or repayment upon presentation of a passbook, certificate of deposit, or other evidence of debt, or upon request of the depositor... Banking Act of 1933, ch. 89, § 21, 48 Stat. 162 (codified as amended at 12 U.S.C. § 378(1)(a) (1988)).

\textsuperscript{85} See AMERICAN BANKERS ASSOCIATION, COMMERCIAL BANKING AND THE GLASS-STEAGALL ACT 2 (1982) ("The primary thrust of the Act was to separate investment bankers from the deposit business, and commercial banks from... the investment banking business."); Investment Co. Inst. v. Camp, 401 U.S. 617, 629 (1971) ("There is no dispute that one of the objectives of the Glass-Steagall Act was to prohibit commercial banks... from going into the investment banking business.").

\textsuperscript{86} ICI, 401 U.S. at 629 (citing Hearings Pursuant to S. Res. 71 Before a Subcomm. of the Senate Comm. on Banking and Currency, 71st Cong., 3d Sess. 40 (1931)). Regardless, many commercial banks still participated in the securities market directly. See AMERICAN BANKERS ASSOCIATION, supra note 85, at 32-33.

\textsuperscript{87} 1931 Hearings, supra note 86, at 1052.

\textsuperscript{88} AMERICAN BANKERS ASSOCIATION, supra note 85, at 36.

\textsuperscript{89} MORISON, supra note 34, at 940.

\textsuperscript{90} Id. at 944.

\textsuperscript{91} See BENSTON, supra note 79, at 1.

\textsuperscript{92} NICHOLAS A. LASH, BANKING LAWS AND REGULATIONS: AN ECONOMIC PERSPECTIVE 126-27 (1987).

\textsuperscript{93} See S. REP. No. 77, 73d Cong., 1st Sess. 6-7, 9-10 (1933); Curtis J. Polk, Banking and Securities Law: The Glass-Steagall Act—Has it Outlived its Usefulness?, 55 GEO. WASH. L.
For years after the Crash of 1929, Senator Carter Glass, author of the Federal Reserve Act, sought to separate investment and commercial banking, having concluded that commercial bank dealings in securities were detrimental to the Federal Reserve system and responsible for the Great Depression. \(94\) Despite his earnest efforts, he was unable to earn the support necessary to effect the separation. It was not until 1933, after Congressional investigations unearthed sordid details regarding commercial bankers' investment activities and the media vilified bankers, that his proposal obtained sufficient backing. \(95\) On June 16, 1933, the Glass-Steagall Act became law, and commercial banking firms could no longer engage in investment banking activities in America. \(96\)

2. **Purposes Served by the Act**

Congress enacted the Glass-Steagall Act in an environment that was decidedly hostile toward bankers, whom Congress perceived as having caused the Crash of 1929 and the Great Depression. The Act's stated purpose was to prevent a recurrence of the abuses that led to those events by erecting an impenetrable wall between commercial and investment banking resources and activities. \(97\) Congress believed that this measure would help restore the shattered public confidence in America's banking system. \(98\)

In the 1971 *Investment Company Institute v. Camp (ICI)* decision, the Supreme Court offered the definitive word on the reasons Congress enacted the Glass-Steagall Act. \(100\) In his opinion reaffirming the force of those reasons, Justice Potter Stewart pointed not only to the obvious concerns addressed by the Act, such as the danger that a bank would invest its own assets in unwise stock or security investments, \(101\) but also to certain

---

\(94\) Morison, *supra* note 34, at 843.

\(95\) Benston, *supra* note 79, at 1-2.

\(96\) *Id.* at 2.


\(98\) See *ICI*, 401 U.S. at 632 ("Senator Glass made it plain that it was 'the fixed purpose of Congress' not to see the facilities of commercial banking diverted into speculative operations by the aggressive and promotional character of the investment banking business.").

\(99\) Polk, *supra* note 93, at 813-14.

\(100\) 401 U.S. 617 (1971).

\(101\) *Id.* at 630. See *American Bankers Association*, *supra* note 85, at 4-5. Because the nation's money supply is created and held in commercial banks, there is a strong public policy reason to ensure their health. *Id.* See also Cargill & Todd, *supra* note 21, at 59 ("[T]he policy basis for Glass-Steagall is prudential—to protect depositors' assets...\)
"subtle hazards" that necessarily exist whenever a commercial bank enters the investment banking field directly or indirectly.102 The affiliation between a commercial and investment bank creates pressures on the commercial banker that might tempt her to act counter to the best interests of the bank depositors and inconsistently with the principles of sound banking practice. Specifically, Justice Stewart pointed to six subtle dangers that the Glass-Steagall Act is designed to prevent:103 1) a bank’s natural temptation to shore up its investment banking affiliate with unsound loans or other aid; 2) the danger that a bank would unwisely give loans to businesses in which it or its affiliates have invested; 3) the impossibility of a bank acting as an impartial source of credit due to its interest in having the business obtain additional funding; 4) the loss of depositor goodwill resulting from customers losing money because of bank investment activities, detrimentally affecting a bank’s reputation as a commercial bank and undermining confidence in the banking system as a whole; 5) a bank’s temptation to loan money with the expectation that at least part of the loan would be used to purchase stock or other securities from it; and 6) the conflict between the promotional interest of an investment banker with the obligation of a commercial banker to give sound, disinterested investment advice. Justice Stewart summed up Congress’ intent in passing the Glass-Steagall Act by explaining that Congress acted to keep commercial banks out of the investment banking business largely because it believed that the promotional incentives of investment banking and the investment banker’s pecuniary stake in the success of particular investment opportunities was destructive of prudent and disinterested commercial banking and of public confidence in the commercial banking system.104

Thus, it is clear that in passing the Glass-Steagall Act, Congress intended to protect depositors by ensuring the safety and soundness of the banking system in different respects. First, protecting against what Justice Stewart calls an “obvious danger,”105 the Act restricts the scope of permissible bank investment to low-risk investments.106 This provision prohibits the investment of bank funds in speculative securities which may jeopard-
ize the solvency of the bank, and by limiting the risk that a bank can undertake, the Act protects against the loss of depositors' funds. Second, as the Supreme Court's opinion in *ICr* makes clear, allowing commercial banks to engage in investment banking activity might create temptations for bankers to act contrary to the principles of sound business practice. By segregating commercial banking activity from the investment banking business, the Glass-Steagall Act prevents these harmful conflicts of interest.107

Of course, completely separating the banking industry into a commercial bank half and an investment bank half harms depositors to the extent that competition between them would be beneficial to consumers and the economy as a whole. There is no question that the Glass-Steagall Act is anticompetitive: it is anticompetitive by definition. The *ICr* opinion tells us that many of the hazards Congress intended to protect against by forbidding competition were themselves anticompetitive.108 The "subtle hazards" the Court points to as one of the reasons for enacting the Glass-Steagall Act are nothing more than instances of grossly anticompetitive behavior and interference with the natural market mechanism for the efficient distribution of funds. These instances include: lending money to an affiliate not because it is a wise business decision for the bank, but because the affiliate is faring poorly; granting affiliates or businesses in which the bank has invested more favorable loan terms because of the affiliation and not because of decreased risk of loss or other quid pro quo; and loaning money on condition that the borrower invest in securities purchased at the bank.109 Congress considered the potential harm to depositors incurred by preventing competition between commercial and investment banks to be less than the harm arising from the grossly anticompetitive behavior exhibited by commercial bankers before the Depression and simply forbade any competition at all.110 Whether there are effective methods to deal with the problem that preserve the benefits of competition is certainly subject to debate.111 For the purposes of this Note, it is sufficient to understand that Congress sought to protect depositors from anticompe-

---


108. *See* 401 U.S. at 630.

109. *Id.* at 630-84.

110. *See id.* at 640.

(The Glass-Steagall Act reflected a determination that the policies of competition, convenience, or expertise which might otherwise support the entry of commercial banks into the investment banking business were outweighed by the "hazards" and "financial dangers" that arise when commercial banks engage in the activities proscribed by the Act.) (citation omitted).

Even though Glass-Steagall is anticompetitive, it is passively anticompetitive as opposed to actively anticompetitive, i.e., its prohibition on all competition is less harmful to consumers than active interference with the market mechanism in the form of favoritism or extortion.

111. Some have argued that the Glass-Steagall Act is largely superfluous in light of the other regulatory frameworks established after the Crash of 1929 to guard against conflicts of interest, self-dealing, and other abuses in the securities industry. *See* William
titive behavior by forbidding competition between investment and commercial banks altogether, despite losing the benefits that flow from competition.

3. **Cracks in the Glass-Steagall Wall**

When enacted over sixty years ago, the Glass-Steagall Act was a strong measure that called for the complete separation of commercial and investment banking activities. Unforeseen advances in technology, however, have blurred the differences between commercial and investment banks, and commercial banks are finding themselves faced with increasing competition from brokerage firms in what have traditionally been commercial banking activities. Bankers, constrained by the prohibitions of the Glass-Steagall Act, have been unable to respond to these increasing domestic and international pressures. In this manner, through legislative interpretation and regulatory action, the Glass-Steagall wall has been crumbling for years.


Given the conditions existing when Glass-Steagall passed, with the country in the throes of depression that was blamed primarily on the investment banking activity of commercial bankers, the circumstances were ripe for rash overreacting. It seems nonsensical to forbid all competition because competition leads some people to do bad things. Why not prohibit the bad things? Why should not the goal of our regulatory structure be to ensure the proper operation of the market mechanism while providing appropriate safeguards? If Glass-Steagall is passively anticompetitive, would not it be preferable to regulate actively to protect the market mechanism? Although interesting and important, these questions are beyond the scope of this Note.


115. Macey, supra note 113, at 226; MISHKIN, supra note 56, at 291; McNees, supra note 79, at 2-3.


The Glass-Steagall Act itself contains a loophole that seems inconsistent with the spirit of the Act. While section 21 of the Act contains very strict language forbidding securities companies from engaging in banking activity "to any extent whatever," the language of section 20 is less restrictive. Section 20 prohibits banks that are members of the Federal Reserve system from being affiliated with any organization "engaged principally" in the investment banking business. This language suggests that a commercial bank may be affiliated with a business organization that engages in investment banking activities which are not its principal business. The relevant question then becomes what it means to be "engaged principally" in the investment banking business.

In a 1978 ruling, the Federal Reserve Board allowed bank holding companies to acquire or form subsidiaries that underwrite and deal in certain securities, known as "bank-eligible securities," that the Glass-Steagall Act permits banks to deal in themselves. Years later, in 1987, several large commercial banks applied to the Federal Reserve Board for permission to broaden the scope of their securities subsidiaries' activities to include underwriting and dealing in municipal bond revenues, mortgage-related securities, consumer receivables, and commercial paper. On its face, this application appears to disregard Glass-Steagall's separation between commercial and investment banking blatantly. Although the Act permits commercial banks to hold these securities as investments for their own account, they are completely prohibited from underwriting or dealing in them. But relying on the "engaged principally" language contained in section 20 of the Glass-Steagall Act, the Board approved the applications and allowed the subsidiaries to underwrite and deal in these "bank ineligible" securities as long as the revenue generated from transac-

120. See Board of Governors of the Fed. Reserve Sys. v. Investment Co. Inst., 450 U.S. 46, 64 (1981) ("In both the Glass-Steagall Act itself and in the Bank Holding Company Act, Congress indicated that a bank affiliate may engage in activities that would be impermissible for the bank itself."). For a discussion of the legislative compromise that led to this more permissive language for affiliates, see Securities Industry Ass'n v. Board of Governors of the Fed. Reserve Sys., 839 F.2d 47, 56-61 (2d Cir. 1988). Those banking affiliates that trade in securities under this provision are usually subsidiaries of the bank holding company that also holds the bank as a subsidiary. As such, they are known as "section 20 subsidiaries." See Sneider, supra note 12, at 351.
123. 12 U.S.C. § 24 (Seventh) (1988). These "eligible" securities include only very low risk governmental bonds. Allowing commercial banks to underwrite and deal in virtually risk-free government debt is perfectly consistent with the Glass-Steagall Act's purpose of protecting depositors' funds. See supra part IIA.2.
tions with them did not exceed five percent (later increased to ten percent) of the gross revenue of the subsidiary averaged over a two-year period. On appeal, the Second Circuit affirmed this interpretation of the "engaged principally" language in section 20 of the Glass-Steagall Act.

The current state of the law in the United States is as follows: bank holding companies are allowed to own both commercial banks and corporations that deal in both eligible and ineligible securities as long as the corporation makes no more than ten percent of its gross revenue from transactions in ineligible securities. Congress and the Federal Reserve Board have adopted this restriction to limit the risk to depositors' funds.

The Japanese also prohibit the intermingling of banking and securities activities, albeit in a different manner and for very different reasons. Until recently, the law in Japan did not allow banks or securities firms to have subsidiaries that competed in the other's market, although banks

127. 73 Fed. Reserve Bull. 475, 485 (1987). The Board required that two additional conditions be met: that the ineligible security underwritten by the subsidiary have no more than five percent of the domestic market share for that particular product, and that the subsidiary limit the amount of each type of security for dealing so as not to violate the underwriting market share requirement. Id. at 485-86.
128. Securities Industry Ass'n v. Board of Governors of the Fed. Reserve Sys. (Bankers Trust III), 839 F.2d 47, 67 (2d Cir. 1988). The court overturned the market share limitations, holding that the Board abused its discretion in imposing them. Id. at 67-68.
129. Interpreting "engaged principally" as a percentage restriction seems logical, but it defies the policy behind the Glass-Steagall Act to a certain extent. If the system is worried about the risk to depositor funds, then it is not clear why the revenue limit is cast as a percentage of permissible revenue rather than an absolute limitation of total revenue that bank affiliates can earn from dealing in ineligible securities before they violate Glass-Steagall. Interpreting section 20 as imposing a percentage limitation will create an incentive for the affiliates to participate more vigorously in the market for eligible securities in order to increase their total revenue so that the money amount of the ten percent limit will be higher, thereby placing a greater amount of depositors' funds at risk. Indeed, that appears to be exactly what bank affiliates have done. See Symons, supra note 112, at 31.

This discrepancy appears more bizarre in comparison to the interpretation of the language in section 32 of Glass-Steagall. Section 32 prohibits "personnel interlocks" between commercial and investment banking firms, providing that no officer, director, or employee of any firm "primarily engaged" in investment banking activities can concurrently serve as an officer, director, or employee of a commercial bank. 12 U.S.C. § 78 (1988). The Board has held that the "primarily engaged" requirement is met in one of two ways: if more than ten percent of the firm's gross revenue comes from underwriting and dealing in ineligible securities, or if the gross revenue from underwriting and dealing in ineligible securities exceeds ten million dollars, regardless of the percentage figure. See Staff Opinion 3-939, 1 Fed. Reserve Reg. Serv. 3-389 (Dec. 14, 1981); Board Letter 3-896, 1 Fed. Reserve Reg. Serv. 3-367 (May 22, 1959). The separate ten million dollar cap provided in the interpretation of section 32 is more consistent with the purpose of protecting depositors' funds than a revenue limit dependent upon a percentage of total revenue. To the extent that the Board should retain a limit on commercial banks' securities subsidiary activities, it should be an absolute rather than a percentage limitation.
130. Cargill & Todd, supra note 21, at 59.
could own as much as five percent of the stock of a securities company.\(^{131}\)
The Financial System Reform Law changed the Japanese financial structure, however, and moved it closer to the U.S. system.

B. Article 65 of the Japanese Securities and Exchange Law

1. History of Article 65

Before World War II, the Japanese financial system operated as a universal banking system.\(^{132}\) The imperial government imposed no legal separation between the banking and securities businesses,\(^ {133}\) and bankers played an important role in the underwriting of public and corporate bonds.\(^ {134}\) Fearing the risk involved in underwriting equity issues and trading in bonds, however, the bankers left these riskier activities to the securities firms.\(^ {135}\)

After the war, the Japanese economy was shattered and needed to be restructured. The Allied forces occupied Japan and helped the Japanese government rebuild its country from the end of the war until 1951.\(^ {136}\) Under the guidance of the General Headquarters for the Supreme Commander of the Allied Powers (SCAP),\(^ {137}\) the Diet drafted and adopted the Securities and Exchange Law in 1948 (SEL), incorporating many of the features of U.S. securities laws.\(^ {138}\) Article 65 of the Law, based directly on the Glass-Steagall Act, imposed a strict separation between the banking and securities industries,\(^ {139}\) but a variant of this separation was not wholly

---

\(^{131}\) Article 65, the Japanese equivalent to the Glass-Steagall Act, did not provide this limitation. It came from the Japanese Anti-Monopoly Law. See infra notes 143-144 and accompanying text.

\(^{132}\) Karihara, supra note 83, at 80.

\(^{133}\) Suzuki, supra note 40, at 99.

\(^{134}\) Id.; Oda, supra note 5, at 303; Karihara, supra note 83, at 80.

\(^{135}\) See Suzuki, supra note 40, at 39. Interestingly, the prevailing commercial banking culture in America also thought it inappropriate for commercial bankers to enter the securities markets directly, even before the Glass-Steagall Act. See supra note 86 and accompanying text.

\(^{136}\) Morison, supra note 34, at 1062-65.

\(^{137}\) President Truman appointed General Douglas MacArthur to be the SCAP at the end of the war, giving him complete authority over Japan and the occupation forces. Id. at 1062.

\(^{138}\) Suzuki, supra note 40, at 39; Cargill & Todd, supra note 21, at 48, 59; Yazawa, supra note 38, at 29. The SEL covers disclosure and reporting requirements, licensing requirements for securities companies, the scope of permitted securities for other financial institutions such as banks, antifraud, and the establishment and operation of the securities exchanges and regulatory structures. Sneider, supra note 12, at 354. It is interesting to note that although the SEL has endured with modifications for over forty-five years, the law was not passed voluntarily—the Diet passed the law under pressure from the Occupation authorities who conditioned reopening the Japanese exchanges on its passage. Yazawa, supra note 38, at 29.

\(^{139}\) Cargill & Todd, supra note 21, at 48. Some commentators argue that, in practice, Japanese banks have been able to underwrite corporate debt by acting as advisor to the issuing corporation and assuming the default risk if the issuing company becomes insolvent. Although such an agreement is illegal under Article 65, it is enforceable as a moral rather than a legal obligation. As such, it does not violate Article 65. See Litt et al., Politics, Bureaucracies, and Financial Markets: Bank Entry into Commercial Paper Underwriting in the United States and Japan, 139 U. Pa. L. Rev. 369, 381 (1990). Although this
unknown in Japan before the war. Japanese banks would underwrite public and corporate bonds, but they voluntarily excluded themselves from certain more risky securities activities\(^\text{140}\) even though it was not required by law. While the SEL was based on the Glass-Steagall Act, it also codified the prevailing banking custom of the period.\(^\text{141}\)

2. **Purpose of Article 65**

The General Headquarters for SCAP officially stated that the policy behind Article 65 was the same policy that motivated the passage of the Glass-Steagall Act—to protect bank depositors from the risks inherent in trust institutions engaging in securities activities.\(^\text{142}\) However, at least two considerations seem to belie this explanation. First, unlike American banks, Japanese banks are free to purchase stocks and other equity instruments as investments for their own account\(^\text{143}\) and can invest without considering the degree of risk. Japan's Anti-Monopoly Law provides the only limit to banks' holdings by prohibiting them from owning more than five percent of another company's shares.\(^\text{144}\) If Article 65 was truly intended to protect depositor funds, then it, like the Glass-Steagall Act, would prohibit bank investment in speculative securities. In addition, the major securities companies in Japan combine the functions of underwriter, broker, and dealer,\(^\text{145}\) an arrangement that is rife with conflict of interest. For instance, a securities company could underwrite a new offering and then advise its brokerage customers to purchase them. It seems unlikely that a regulatory structure that tolerates such a blatant conflict of interest would concern itself with the "subtle hazards" of mixing banking and securities activities.\(^\text{146}\)

---

activity may not be trivial, it obviously is insufficient from the banks' perspective or they would not have pushed for reform of Article 65 so strongly. In addition, to the extent that it does occur, this phenomenon will almost certainly diminish with the increasing globalization of financial markets and the attendant competition. *See, e.g.*, Louis Turner, *Japan Suffers in the Slump*, Int'l Mgmt., Mar. 1994, at 30, 31 ("There are clear signs that competitive pressures are starting to erode some of the more distinctive Japanese practices.").

142. Id.; Cargill & Todd, *supra* note 21, at 59.
143. Suzuki, *supra* note 40, at 40 ("Article 65 ... places no controls whatsoever on the acquisition of securities and equities for investment purposes."); Nakajima, *supra* note 54, at 188. American corporations are limited to purchasing marketable debt instruments which are thought to be very safe investments nearly indistinguishable from an outright loan. *See supra* note 106 and accompanying text.
146. A persuasive argument could also be made that protecting depositors' interests could not have been the rationale behind the adoption of Article 65 because it was not needed for this purpose, since bankers refrained from dealing in certain risky investments, giving the securities companies a monopoly over those functions. In that man-
In fact, the true force motivating the enactment of Article 65 seems to have been the desire to cultivate a domestic securities industry free of competition from the larger and better established banking sector.\textsuperscript{147} This purpose is perfectly consistent with the separation and specialization that characterized Japanese finance in the years following the war.\textsuperscript{148} The Japanese restructured their economy so as to revive particular sectors of industry by providing a system of banks to serve only that industrial sector. Separating the financial system in this manner displayed an enormous amount of skepticism in the long-term benefits of competition, which is perfectly understandable given the short-term goal of rebuilding Japan. Rather than concerning themselves with the efficiency gains to be made by pitting financial institutions against one another, the Japanese sought to protect each of the financial institutions and thereby protect and develop each industrial sector.\textsuperscript{149} In typical Japanese style, financiers and bankers worked hand in hand with industrialists to rebuild Japan: an arrangement of cooperation rather than competition.

Japanese officials felt that a well-developed securities market was necessary to rebuild Japan into a modern industrialized nation. For that reason, they structured their economic system so as to protect the securities markets from the traditional dominance of the \textit{zaibatsu} banks engaged in underwriting.\textsuperscript{150} In this manner, Japanese officials hoped that the securities firms could raise the equity capital desperately needed by new businesses in Japan, thereby helping to rebuild and strengthen the economy. They also hoped that the securities firms would simultaneously become stronger and better able to raise equity capital for future businesses.\textsuperscript{151}
The strategy worked, and today, the securities firms in Japan rank among the largest and most powerful companies in the country. It would seem, then, that the original rationale for separating the banking and securities industries has weakened considerably since the end of World War II. As the rationale has weakened, the pressure to lower the boundary between the two industries has increased.

3. Cracks in the Article 65 Wall

As the Japanese accumulated financial assets in the high-growth period following World War II, they became increasingly sensitive to the profitability of their investments. When the demand for capital diminished, the Japanese had the luxury of "shopping around" for the most profitable investments. Borrowers found lower cost funding, and investors earned higher rates of return outside of Japan. At the same time, Japanese companies began depending more heavily on equity finance and commercial paper rather than loans, which cut into banks' profit margins. Consequently, the banks lost a significant share of their traditional deposit and

quickly enough or in sufficient quantity. As a result, bank lending remained the primary source of capital for business. In fact, it was not until the demand for capital decreased and the Japanese economy slowed its growth that the banks lobbied for entry into the securities markets. See infra notes 154-60 and accompanying text.

152. Today, Nomura Securities is the largest securities firm in the world with a market value in excess of $50 billion. Mishin, supra note 56, at 289. To put the size of the Japanese securities firms into perspective, the smallest of the "Big Four," Yamaichi Securities, is over five times larger than Merrill Lynch, the largest U.S. firm. Id. See also J. Mark Ramseyer, Legal Rules in Repeated Deals: Banking in the Shadow of Defection in Japan, 20 J. LEGAL STUD. 91, 99-100 (1991); Frances Rosenbluth, The Political Economy of Financial Reform in Japan: The Banking Act of 1982, 6 UCLA PAC. BASIN L.J. 62, 68 (1989). One commentator has argued that Congress actually passed the Glass-Steagall Act for the same reason that the Japanese enacted Article 65, which was to benefit investment bankers as a special interest group. See Jonathan R. Macey, Special Interest Groups Legislation and the Judicial Function: The Dilemma of Glass-Steagall, 35 EMORY L.J. 1 (1984).


154. Id. at 7-8; Jones, supra note 9, at 405.

155. RESEARCH COUNCIL REPORT, supra note 6, at 6 ("The accumulation of financial assets has been accompanied by a demand for more diversified and sophisticated financial products and services."); id. at 13.

156. David G. Litt, Work in Progress at the Ministry of Finance: Proposals for Restructuring the Japanese Financial Services Industry, 12 U. PA. J. INT'L BUS. L. 711, 719 (1991); Jones, supra note 9, at 405-06; Mabuchi, supra note 153, at 15-16; RESEARCH COUNCIL REPORT, supra note 6, at 9

(In the environment of internationalization of economy and advancement of financial techniques which facilitate the vigorous international flow of capital, corporations are now able to determine in which markets to invest and to procure capital, strictly based on such factors as profitability of the financial products offered in the world markets and the convenience of each market.)

157. Japan's Bankers Breach the Wall, ECONOMIST, Nov. 26, 1994, at 85 ("[I]n Japan as elsewhere, firms have found that raising capital by issuing bonds and shares is cheaper than borrowing from banks.").
loan markets to securities firms at home and abroad. The banks began pressuring the MOF to allow them to engage in a broader range of securities transactions, believing that their ability to offer a wider array of services would help them retain profits and compete effectively internationally. The securities industry, for its part, worried that the banks' strong relationships with corporate Japan and their large branch networks would make it difficult for them to compete with the banks for underwriting and retail brokerage business. Balancing these concerns, the MOF amended the Banking and Securities Laws in 1981 to allow banks to deal in public bonds and sell them over the counter and again in 1988 to permit banks to trade public bond options. The MOF stopped short, however, of allowing banks to engage in retail stock brokering, the securities firms' most profitable business and the primary business of the smaller securities firms. Throughout the 1980s, the barriers between the banking and securities industries slowly eroded. Japanese banks were permitted to establish securities affiliates outside the country even though they competed with domestic Japanese securities firms for overseas underwriting business. Even in securities activities considered outside the reach of the banks, the banks profited indirectly by becoming affiliated with securities firms through mutual stock ownership. Nevertheless, the banks still sought to expand their underwriting activities further by seeking relaxation of the Article 65 restrictions. After years of deliberation and research beginning in 1985, the MOF responded with the Financial System Reform Law of 1992.

III. The Financial System Reform Law of 1992 and Innovation

A. Provisions of the Reform

1. The Reform in General

The reform’s central goal was to liberalize the Japanese economy by encouraging competition between financial institutions, thereby benefiting Japanese consumers. The system of specialization and protection of Japanese financial institutions had served the purpose for which it was originally established: Japan had been rebuilt. Almost fifty years had passed since the end of World War II, and the Japanese had developed the
second largest economy in the world. The system's rigidity had become a burden, restricting financial institutions' ability to produce innovative financial products and services. Since each specialized institution dealt exclusively with a particular business area, there was little need for innovation to attract new business. In addition, various restrictions and customs arising out of the vertical division of the Japanese financial system stifled the development of new financial products and services.

To encourage competition and thereby promote innovation, the Japanese reformers sought to ease the boundaries that had separated their specialized financial institutions for years, allowing them to enter one another's turf. They began to phase out the distinction between long-term credit banks, ordinary banks, and trust banks. The Financial System Reform Law broadened cooperative financial institutions' scope of activities to make them almost indistinguishable from ordinary banks and collapsed the distinction between long-term and short-term credit by allowing ordinary banks to deal in long- and medium-term loans. Most importantly, the reform allowed banks and securities firms to compete with one another in their respective areas of traditional dominance.

The main concern about abolishing the distinction between the different types of banks was their varying sizes. The city banks are by far the largest of all the Japanese banks and have the most extensive branch network. The reformers believed that the city banks' status as international banks gave them a tremendous advantage over the other types of banks, to the extent that the smaller banks might have difficulty competing with them following a wholesale deregulation. To deal with this situation, the reform allowed the banks to enter into new business fields only through the operation of separate subsidiaries and empowered the MOF to determine the degree of control parent banks were to exercise over these subsidiaries.

2. The Separated Subsidiary Approach

Both the Research Council and the Securities Council examined several options regarding the lowering of the barrier between the various financial sectors, including the banking and securities industries. They considered using a piecemeal approach—a case-by-case easing of restrictions. This had been the response of choice by the Japanese government in the

167. The Big Bang, Japanese-Style, supra note 8, at 56.
168. Research Council Report, supra note 6, at 9; id. at 14 ("Under the existing vertical division system, which limits the range of products and services each financial institution can handle, it is difficult for financial institutions to take advantage of technological innovations and to meet the diversifying needs of the financial user.").
169. Id. ("[E]ven if a new product is developed involving multiple financial sectors, its offer to the user tends to be restrained since this gives rise to confrontation between the sectors, chiefly concerning the problem of specifying the providers of the products.").
170. Id. at 10.
171. The reformers continually speak of the necessity of "achieving a level-playing field." Id. at 20.
172. Id. at 20-21.
past.\textsuperscript{173} This time, however, the reformers considered this response to be too disorganized and removed from actual reform to be worthy of implementation.\textsuperscript{174} It would also have required expensive and difficult inquiries into the intricacies of particular circumstances. In essence, a case-by-case reform would have been less of a reform and more of an ongoing negotiation between financial institutions about the scope of their businesses.\textsuperscript{175} The reformers, however, were seeking to enhance competition, not to create a process which involved compromise, coordination, and accommodation.

A proposal to introduce universal banking to Japan was at the other extreme. Under a universal banking system, all financial institutions would be allowed to engage without restriction in all types of financial transactions. Many countries, including Germany, France, and Italy, have this type of financial system.\textsuperscript{176} The system is efficient because it permits the consumer to complete all desired transactions in one location from one provider.\textsuperscript{177} In addition, it allows financial institutions to diversify their operations, thereby decreasing risk and enhancing stability.\textsuperscript{178} While universal banking has many advantages, there are many problems associated with allowing expansive financial power to rest in one entity. Foremost is the creation of difficult conflicts of interest as financial institutions begin to operate in a variety of roles.\textsuperscript{179} The Financial System Research Council thought that the introduction of universal banking was too radical for this reform, but it did not rule it out for the future.\textsuperscript{180}

The Japanese also considered structuring their financial system exactly like the U.S. financial system, with holding companies owning several financial institutions from various sectors.\textsuperscript{181} However, because in Japan holding companies are illegal under Article 9 of the Anti-Monopoly Law, this suggestion was not feasible without further legislative reform, and "it [was] not considered appropriate to seek a revision of that law for the sake of financial system review alone."\textsuperscript{182} A viable alternative, however, was the multifunctional subsidiary which would allow securities companies and banks to enter one another's markets through the establishment of wholly-owned subsidiaries that would be able to enter


\textsuperscript{174} Jones, \textit{supra} note 9, at 413.

\textsuperscript{175} Litt, \textit{supra} note 156, at 725.


\textsuperscript{177} Litt, \textit{supra} note 156, at 725.

\textsuperscript{178} Garten, \textit{supra} note 176, at 161.

\textsuperscript{179} \textit{Research Council Report}, \textit{supra} note 6, at 21. For an excellent discussion of other problems with introducing universal banking in Japan, see Litt, \textit{supra} note 156, at 725-26.

\textsuperscript{180} Miyazawa, \textit{supra} note 173, at 250.

\textsuperscript{181} See \textit{supra} notes 118-129 and accompanying text.

\textsuperscript{182} \textit{Research Council Report}, \textit{supra} note 6, at 21; Miyazawa, \textit{supra} note 173, at 248-49.
into a range of new activities, much like a universal bank.\textsuperscript{183} The subsidiaries would be restricted to the capital markets or to activities other than deposit-taking. In this manner, large companies would enjoy the efficiency advantages of universal banking while consumers would continue to benefit from the safety of the existing system, since all new activities would be confined to the subsidiary.\textsuperscript{184} The Japanese thought that such an approach had a synergistic advantage and would promote balanced competitive conditions in the financial markets.\textsuperscript{185}

Although the multifunctional subsidiary approach obviated the need to legalize holding companies, Article 11 of the Anti-Monopoly Law presented a problem since it forbids companies from owning more than five percent of the outstanding shares of another company's stock.\textsuperscript{186} Thus, the multifunctional approach would require either amending Article 11 or granting exemptions to financial institutions that wished to establish subsidiaries. Despite the potential benefits such a system would bring, it was not adopted for many of the same reasons the universal banking system was not adopted, including the possibility of harmful conflicts of interest.\textsuperscript{187}

In order to capture the advantages of the multifunctional subsidiary approach while avoiding the disadvantages, specifically the potential for conflicts of interest, the reformers adopted a separated subsidiary approach. Under this approach, financial institutions must establish a separate subsidiary for each new field of business they wish to enter (hence the term "separated subsidiaries") with each subsidiary able to operate in only one financial market. In order to enter the securities business, banks could establish securities subsidiaries—corporations wholly owned by the banks and engaged in activities as a securities company. Likewise, to engage in the banking business, securities firms could establish banking subsidiaries. Conflicts of interest are diminished by confining the different types of financial activity to separated subsidiaries. This structure would also provide strong continuity with the existing system and increase competition in any given financial sector.\textsuperscript{188} Because the parent institution owns 100\% of the subsidiary, the separated subsidiary approach raises concerns regarding the ownership limitation contained in Article 11 of the Anti-Monopoly Law.\textsuperscript{189} Rather than amend Article 11 to cover all separated financial subsidiaries, the Japanese opted for case-by-case exemptions to the Article 11 limitation, to be granted by the Japanese Fair Trade Commission.\textsuperscript{190}

\begin{itemize}
\item \textsuperscript{183} Jonathan R. Macey, \textit{The Inevitability of Universal Banking}, 19 Brook. J. Int'l L. 203, 221-22 (1993).
\item \textsuperscript{184} Litt, \textit{supra} note 156, at 727.
\item \textsuperscript{185} \textit{Research Council Report}, \textit{supra} note 6, at 21.
\item \textsuperscript{186} \textit{See supra} note 144 and accompanying text.
\item \textsuperscript{187} \textit{Research Council Report}, \textit{supra} note 6, at 21.
\item \textsuperscript{188} Litt, \textit{supra} note 156, at 728.
\item \textsuperscript{189} \textit{See supra} note 185 and accompanying text.
\item \textsuperscript{190} \textit{Research Council Report}, \textit{supra} note 6, at 22.
\end{itemize}
Japanese lawmakers adopted the separated subsidiary approach on the recommendation of both advisory councils and the MOF. The new law is contained in amended Article 65-3 of the Securities and Exchange Law. Article 65-3, entitled “Securities Business Conducted by a Financial Institution Through a Subsidiary,” succinctly states the essence of the reform:

The provisions of Article 65 shall not preclude the Minister of Finance from issuing a license [to engage in the securities business] . . . to a joint stock company in which a bank, trust company, or such other financial institution as may be prescribed by a Cabinet order owns a majority of its shares.\[^{191}\]

While the reform enables banks to compete against the securities firms, the new law basically keeps Article 65 intact. No bank may engage in the securities business directly, but they will be able to profit from the securities dealings of their wholly owned subsidiaries.

B. Financial Innovation

The American financial system is generally considered to be the most dynamic and innovative system in the world.\[^{192}\] Many things Americans now take for granted were the recent products of financial innovation, including credit cards, automated teller machines, money market mutual funds, and variable interest rates.\[^{193}\] While much has been written about the stimuli for and beneficial effects of financial innovation,\[^{194}\] one thing is clear: financial innovation occurs because the innovator is trying to make more money.\[^{195}\] This is classic economics—all market participants are assumed to be rational actors, and rational actors always attempt to maximize their financial positions. They will, therefore, do whatever they can within the applicable constraints, such as law and morality, to increase their total wealth. Participants in capital markets buy and sell financial products and services, and the seller offering the most attractive financial product or service stands to make the most money. What would be considered the most attractive financial product or service depends upon many things: market conditions, the needs and desires of market participants, applicable laws and regulations, and the tax structure, to name a few. Through the process of creating and marketing new financial products

---

\[^{191}\] SEL, supra note 12, art. 65-3.
\[^{192}\] See supra note 32 and accompanying text.
\[^{195}\] See Mishkin, supra note 56, at 297 ("[I]nnovation is produced by the desire of individuals and businesses to maximize profits.").
and services, a financial innovator can tailor the attributes of his innovation to make it more attractive to consumers than those already in existence or those likely to be marketed by rivals. The nature of the innovation depends upon the market pressures that sparked the innovation in the first place. Finally, many types of stimuli prompt financial innovation, including changes in legal and regulatory rules, taxes, technological improvements, increased efficiencies in collecting and processing information, and extreme interest rate fluctuations.

The desire to avoid existing regulations that hinder profits is a very strong motivating force for financial innovation. For instance, the United States Banking Act of 1933 prohibited the payment of interest on checking accounts. If a bank could somehow figure out a way to pay interest on checking accounts legally, it would attract more customers and increase profits, because all other banks were prohibited from doing so. In fact, in 1970, a Massachusetts bank discovered that in order for an account to be a checking account the depositor must have the legal right to demand withdrawal of her funds immediately. By withholding that legal right to withdraw on demand but recognizing it in practice, the account was functionally indistinguishable from a true checking account, and the bank was able to pay interest on the account. In this way, NOW (negotiable order of withdrawal) accounts were born.

---

196. See, e.g., Sean Becketti, The Role of Stripped Securities in Portfolio Management, ECON. Rev., May 1988, at 20 ("A wave of new financial products has been generated in recent years by the combined pressures of increased financial market volatility, technological innovation and regulatory change."); Shenker & Colletta, supra note 194, at 1370. See also Mabuchi, supra note 153, at 8-9 (describing Japanese banks' introduction of certificates of deposit, or CDs, to circumvent interest rate regulation).

197. See Richard C. Aspinwall, On the "Specialness" of Banking, 7 ISSUES IN BANK REG. 16, 19 (1983) ("Incentives to develop new instruments or new ways to process old instruments invariably stem from the burdens of regulation applying to established arrangements or institutions."). One commentator has described this process of financial innovation resulting from attempts to avoid regulation as "loophole mining." Edward J. Kane, Accelerating Inflation, Technological Innovation, and the Decreasing Effectiveness of Bank Regulation, 36 J. Fin. 355, 355 (1981). Innovations that result from a desire to avoid regulations usually will have the effect of eliciting new regulations, and sellers will, in turn, innovate in order to avoid those new regulations. See Mishkin, supra note 56, at 311 ("Just as financial institutions change in response to regulation, the regulatory authorities change their regulations in response to financial innovation. This process can be thought of as a cat-and-mouse game between the financial institutions and the regulators in which they adapt continually to each other.").


199. Mishkin, supra note 56, at 309. Another way to avoid the restriction on paying interest on checking accounts is to keep all of the depositor's funds in a savings account earning interest, electronically transferring exactly the amount of a check to be cashed just at the moment the check is cashed. Technically, interest is being paid only on the savings account, but functionally the account is a checking account. Id. at 310.

Similarly, commercial paper evolved at the end of the eighteenth century to fill the gap between available and demanded credit in many parts of the United States, particularly in the South and the West, where there was a relatively low concentration of banks providing needed credit for rapidly growing areas of the country. Because American banks were limited to operating within one state at best, and one branch at worst, credit
Examples of innovation stemming from a desire to avoid regulation can be found in many other countries. After World War II, the Japanese Diet enacted the Anti-Monopoly Law\(^{200}\) in an attempt to break up the powerful *zaibatsu*.\(^{201}\) Although the Law outlawed holding companies, a new system of headless corporate groups known as *keiretsu* evolved to take their place.\(^{202}\) A *keiretsu* is a group of companies, centered around a main bank, that mutually own one another's shares within the limit imposed by the Anti-Monopoly Law.\(^{203}\) A *keiretsu* can therefore be seen as a form of *zaibatsu* modified to fit under the strictures of the Anti-Monopoly Law. They developed because the Japanese preferred to work in a *zaibatsu*-like system rather than the anti-monopolistic American system imposed upon Japan after the war. Therefore, Japanese companies formed these innovative *keiretsu* groups to circumvent the Anti-Monopoly Law.\(^{204}\)

Increased interest rate risk will also spark innovation of products designed to decrease that risk.\(^{205}\) At the same time, advances in technology lower the cost of providing new financial services and therefore make the process of financial innovation easier.\(^{206}\) There are two underlying processes that strongly influence financial innovation. The first, which has already been mentioned, is that innovation occurs because of a desire on the part of the innovator to make more money. The second, which is inherently related to the first, has been implicit in our discussion but has yet to be explicitly articulated: competition breeds innovation because other competitors are also trying to make more money.

For illustrative purposes, assume that the market is a zero-sum game—what one seller makes, another loses.\(^{207}\) Competition is not abso-
lutely necessary for financial innovation to occur—a monopolist might still innovate in order to avoid regulations or taxes—but competition is a powerful spark to innovate.208 Innovation is driven not only by the desire for increased profits, but also by increased competition since increased competition leads to innovation in an attempt to compete more effectively and thereby increase profits. The operation of these two concepts in conjunction, competition and the desire to maximize profits, leads to financial innovation.

There are three important principles to understand when analyzing competition and its effect on financial innovation. First, the greater the competition, the greater the pressure for innovation.209 This flows naturally from our discussion. Because the market is a zero-sum game, competition decreases profits and increases the pressure for innovation. Competition is highly effective in kindling innovation because a successful new product created to compete with another seller's product will heighten the competition and motivate the competitor-seller to produce another innovative product.210

Second, the greater the number of market participants, the greater the competition.211 Because the market is a zero-sum game, profits decrease as the number of market participants increases.212 When profits decrease, competition will increase as firms fight to regain their profit margins. Therefore, the greater the number of market participants, the greater the pressure for innovation.

208. See Willin, supra note 114, at 5 ("The necessity for diversifying and remaining competitive with other financial services institutions, the desire to increase fee-based income, and the need to respond to new customer demands for choices and options are some of the reasons banks have developed new securities-related products.").

209. See Financial Services Competitiveness Act of 1995, Hearing Before the House on Banking and Financial Services, 104th Cong., 21 (Feb. 28, 1995) ("[T]he one thing we have learned is that the more competition in financial services as indeed elsewhere, the better it is for consumers, because the types of products which we now have in finance are really quite extraordinarily more useful [and] sophisticated . . . " ) (statement of Alan Greenspan, Chairman of the Federal Reserve Board of Governors), available in LEXIS, News Library, CURNWS File.

210. See Howard H. Newman, Comment, in THE DEREGULATION OF THE BANKING AND SECURITIES INDUSTRIES 341, 341 (1979) ("[S]hort-term credit was traditionally provided by banks through their loan facilities. To service their clients' short-term credit needs, brokers countered by pioneering and promoting the commercial paper market. Banks in turn have introduced below prime-rate borrowing facilities to recapture a portion of this demand for short-term funds."); Mabuchi, supra note 153, at 8-9 (describing banks' introduction of CDs in response to competition from the securities sector and its effect of increasing competition between banks and securities companies).

211. It is easy to imagine circumstances under which having fewer competitors would increase competition, such as when two or more small firms merge to form a large firm with greater competitive potential than the sum of that of its components individually. We are concerned, however, with the general case of market entry, not competitive merger.

212. See Asako Ishibashi, Subsidiaries of Big Banks Bow in as Securities Brokers Competition Intensifies in Bond Transactions, NIKKEI WKLY., Nov. 28, 1994, at 18 ("The more crowded and competitive the market becomes, the thinner the profit margins are likely to be for all competitors.").
Third, because market participants often have varying backgrounds, experiences, and resources, they each bring different perspectives and ideas to the marketplace. They use their ingenuity to create products better than those already in existence and better than those they think their rivals can produce. Their ingenuity, however, is necessarily a function of their backgrounds and experiences, so different participants will innovate in different ways. This is an important point to understand—the same stimulus will produce different innovations since any problem can be solved in a myriad of ways. This is a desirable result because consumers will benefit from having a choice of financial products and services, rather than just one. Different consumers will prefer different solutions, but the consumers get to make that choice—they can choose the financial products and services which best fit their individual needs.\footnote{213}

With these principles in mind, we can now examine the Japanese financial system reform to determine whether the substance and implementation of the reforms will promote the creation of new and innovative financial products and services as the reformers hoped it would.\footnote{214}

C. Will the Reform Lead to New and Innovative Products and Services?

By relaxing Article 65, the Japanese are seeking to encourage those innovations that would arise from the increased competition between the securities and banking industries for the same funds.\footnote{215} The Japanese hope that increased competition will cause banks and securities firms to introduce more convenient and efficient financial products and services in order to attract business away from their new competitors.\footnote{216} The question becomes whether the changes the Japanese have made to their financial system in the Financial System Reform Act will produce the desired effects.\footnote{217} In other words, will the newly fashioned financial system result

\footnote{213. Clearly this is a desirable result. Imagine a group of consumers who each purchase a particular product because it generally fits his or her needs. If there was another product with different characteristics that would perform the same function, some of the group of consumers would begin purchasing the new product in lieu of the old if they found its characteristics more desirable. Necessarily, the overall purchasing satisfaction of this group of consumers has increased. Taken to its logical extreme, each consumer would then have a custom-designed product.}

\footnote{214. See \textit{supra} notes 19-20 and accompanying text.}

\footnote{215. The separation between the banking and securities industries is itself a regulation that has given rise to a pressure to avoid its operation. See Phillips, \textit{supra} note 206, at 352 ("Walls [between investment and commercial banking] can of course be erected—as the Maginot Line was—only to invite flights over or invasions around it."); Newman, \textit{supra} note 210, at 341-42 ("[W]ithout Glass-Steagall, it is difficult to imagine what form of economic pressures would have caused lending institutions to develop commercial paper. . . ."); Mishkin, \textit{supra} note 56, at 293.}

\footnote{216. \textit{Research Council Report}, supra note 6, at 9 ("It is now necessary to reform the existing system and encourage competition between the different categories of financial businesses based on the idea of offering financial products and services of better quality to the Japanese people through further competition.").}

\footnote{217. The mere fact that the securities industry has been separated from the banking industry in Japan cannot provide a satisfactory explanation for the lack of new financial products and services. For example, the banking and securities industries are also sepa-}
in more competition between banking and securities firms?\textsuperscript{218}

Interestingly, while the Japanese pledge that their reform goal is to promote competition as a vehicle for sparking innovation, they appear to take back with one hand what they give with the other. Although the reforms are nominally intended to encourage competition, both their substance and their implementation display a distrust of competition and bode poorly for the future of Japanese financial innovation.

\textbf{1. Implementing the Reform}

The problem with the reform is fundamental: it is not really deregulation at all. Rather, it is a re-regulation.\textsuperscript{219} The Diet has granted the MOF an enormous amount of discretionary power over the reform's substance.\textsuperscript{220} Articles 16(2) and 16(3) of the amended Banking Law indicate that the MOF has the power to determine which firms can form subsidiaries, which firms can be acquired as subsidiaries, and in which types of transactions a firm and its subsidiaries can engage.\textsuperscript{221} Additionally, since a bank must apply to the Japanese Fair Trade Commission for permission to own stock in a company in derogation of the Anti-Monopoly Act,\textsuperscript{222} the MOF has

\textsuperscript{218} This is the only question we need to answer. If the reforms do indeed result in more competition, this will increase the pressure for and ultimately lead to innovation.

\textsuperscript{219} Yuichi Shono, a general manager at the Bank of Tokyo, quipped "[d]eregulation is happening in a very regulated way." \textit{The Big Bang, Japanese-Style}, \textit{supra} note 8, at 56. \textit{See also} Henny Sender, \textit{Japan's Not-So-Mighty Banks, INSTITUTIONAL INVESTOR}, Nov. 1990, at 74 ("To MOF officials the very term ‘deregulation’ sounds ... too messy ...; they prefer ‘rationalization’ or ‘consolidation’ or even ‘reregulation.’").

\textsuperscript{220} Cargill & Todd, \textit{supra} note 21, at 81 ("[Japanese regulators have] sought to guide the direction, and control the speed, of liberalizations as much as possible.").

\textsuperscript{221} Banking Law, \textit{supra} note 57, arts. 16(2), (3) (as amended by the Financial System Reform Law) (translation by author).

\textsuperscript{222} \textit{See supra} notes 188-89 and accompanying text.
even more power to police the operation of the reform and to control
competition. The discretionary power delegated to the MOF to control
the pace and extent of reform is consistent with the general tendency in
Japan "to give governmental agencies a predominant role in the enforce-
ment of law."223 One commentator has even suggested that far from
being the liberalizing deregulation it had been touted as being, the Finan-
cial System Reform Act could be a "brilliant maneuver by the MOF" to
regain its dominance in the field of financial regulation after recent scan-
dals and other concerns have diminished its prestige.224

The MOF's position, known as the "soft-landing" policy,225 is that the
reform should proceed gradually, taking account of the currently poor
market conditions and the likely drastic effect on smaller securities firms
caused by increased competition in the securities business.226 The Japa-
nese government wants to give the country's beleaguered brokerage
houses a chance to recover from the Tokyo market collapse before exposing
them to potential competition from banks' subsidiaries.227 The MOF
is accomplishing this goal in two ways: by staggering the start dates of the
banks' entry into the securities business and by limiting the scope of their
securities subsidiaries' permissible business activities to dealing in corpo-
rate and government bonds.

The MOF has staggered entry into the securities business by allowing
banks to establish securities subsidiaries in stages. IBJ Securities, LTCB
Securities, and Norinchukin Securities, subsidiaries of the Industrial Bank
of Japan, the Long-Term Credit Bank of Japan, and the Norinchukin
Bank, respectively, were the first to enter the market on July 26, 1993.228
Although the MOF intended to keep the powerful city banks from estab-
lishing securities subsidiaries until after the entry of other participants,
Daiwa Bank acquired the ailing Cosmo Securities in a bailout plan
announced on August 13, 1993, and has been operating in the securities
markets since then.229 The MOF approved the takeover as an extraordi-
nary case," giving Daiwa a lead over the other city banks in entering the
securities field in return for rescuing the debt-ridden, second-tier securi-
ties company.230 Mitsubishi Trust and Banking and Sumitomo Trust and
Banking both established securities subsidiaries in September 1993, and
Yasuda Trust and Banking's securities subsidiary began operations in June 1994.\textsuperscript{231} The MOF allowed Asahi Bank to be the first of the city banks to establish a securities subsidiary in July 1994.\textsuperscript{232} The MOF selected Asahi Bank because it was thought to be weaker than the other city banks and therefore less competition for the securities industry.\textsuperscript{233} The MOF did not allow other city banks to enter the securities field until November 24, 1994, when it allowed six to enter. On that date, DKB Securities, Sakura Securities, Fuji Securities, Mitsubishi Diamond Securities, Sanwa Securities, and Sumitomo Capital Securities, subsidiaries of Dai-Ichi Kangyo Bank, Sakura Bank, Fuji Bank, Mitsubishi Bank, Sanwa Bank, and Sumitomo Bank, respectively, began their operations.\textsuperscript{234} The MOF issued a license to Tokai Bank's securities subsidiary, Tokai International Securities, on February 6, 1995,\textsuperscript{235} and Hokkaido Takushoku Bank is expected to establish its securities subsidiary in the spring of 1995,\textsuperscript{236} making it the ninth major commercial bank to establish a securities subsidiary.\textsuperscript{237} Mitsui Trust and Banking has already announced its plans to set up a securities subsidiary to begin operations on April 1, 1995.\textsuperscript{238}

In an effort to protect the small securities firms that rely heavily on retail stock brokering for the majority of their business,\textsuperscript{239} the MOF has limited the scope of the new securities subsidiaries' permissible activities. Specifically, the subsidiaries have been denied access to the equities market—they are not allowed to engage in securities brokering.\textsuperscript{240} To protect existing brokerages, the subsidiaries' activities will be limited to underwriting and brokering government and corporate bonds.\textsuperscript{241} Allowing banks' securities subsidiaries to deal in the bond market will increase the compe-

\begin{itemize}
\item \textsuperscript{232}Six More City Banks Establish Brokerage Subsidiaries in Japan, 63 Banking Rep. (BNA) No. 21 at 847 (Dec. 5, 1994).
\item \textsuperscript{233}Hijiri Inose, Head Start Seen No Big Lift for Asahi Bank Securities Unit: Unclear Strategy, Bond Slump to Hurt Debut of First City Bank Securities Subsidiary, Nikkei WsLY., March 14, 1994, at 12.
\item \textsuperscript{235}MOF Licenses Tokai Bank Securities Subsidiary, Japan Econ. Newswire, Feb. 6, 1995, available in LEXIS, News Library, CURNWS File.
\item \textsuperscript{236}MOF Set to Allow Tokyo Banks to Enter Trust Business by Summer, 64 Banking Rep. (BNA) No. 5, at 237 (Jan. 30, 1995).
\item \textsuperscript{237}It will actually be the tenth city bank to operate in the securities business via a subsidiary. Since Daiwa acquired a subsidiary in an emergency bailout plan, it is unnecessary for Daiwa to establish its own. See supra notes 231-32 and accompanying text. The Bank of Tokyo has decided to concentrate on the trust business, having established a trust bank subsidiary in October 1993. City Banks to Crack Broker's Hold in 3 Stages, Jiji Press Ticker Service, Mar. 2, 1994, available in LEXIS, News Library, CURNWS File.
\item \textsuperscript{239}Litt, supra note 156, at 721.
\item \textsuperscript{240}City Banks to Crack Brokers' Hold in 3 Stages, Jiji Press Ticker Service, Mar. 2, 1994, available in LEXIS, News Library, CURNWS File.
\item \textsuperscript{241}Ishibashi, supra note 212.
\end{itemize}
tition faced by the larger Japanese brokers, but it will have a limited competitive impact on the smaller brokers who deal primarily in stocks.  

2. Analyzing the Implementation

To determine the reform's likely impact on the Japanese financial system, we can examine the reform according to the three principles developed above. First, the MOF is seeking to encourage financial innovation in its domestic market. To accomplish this, the MOF must ensure a substantial amount of competition in the Japanese financial sector. To encourage competition, the Japanese reformed their securities and banking laws to allow banks and securities companies to compete with one another through the operation of separated subsidiaries. Unfortunately, however, the manner in which the Japanese introduced reform to their financial system defeats the main goal of the reform. The MOF argues that it must proceed slowly to lessen the impact on the market. This is a rather odd situation: the MOF hopes that the increased competition between the banks and securities companies will produce innovative financial products and services, but the MOF is introducing the reform in such a way that minimizes any resulting competition.

The MOF is trying to control competition by allowing certain firms to gain access and become entrenched in the market before other competitors enter. Without allowing substantial competition, there will be no incentive for the financial sector to innovate to attract customers. Innovation in financial products and services is one method a firm can use to gain a competitive edge over another, and early entry into the market is another. To the extent that the MOF is succeeding in diminishing competition by allowing early entry, there will be less pressure for financial innovation.

Second, the greater the number of firms the MOF allows into the securities business, the greater competition there is likely to be. The Diet has given the MOF the authority to choose those banks that may establish subsidiaries in the securities market and when they may begin operations. Thus, the MOF is allowed to admit a few new entrants, observe the effect the new entrants have on the market, and then decide whether and when to admit additional entrants. Of course, the MOF's exercise of this power could not be more at odds with its stated goal of increasing competition

---

243. See supra notes 209-14 and accompanying text.
244. See Michael Hirsh, It's Bankers Versus Brokers As Japan's Glass-Steagall Starts To Break Down, INSTITUTIONAL INVESTOR, Apr. 1993, at 25, 25 ("The ever cautious Ministry of Finance has every intention of keeping the competition orderly and limiting the crossover between industries.").
245. See supra note 227 and accompanying text.
247. A major securities house official stated that “[b]anks already in the securities business, in particular the Industrial Bank of Japan, have been trying hard to establish their market share before we join.” Fujisaki, supra note 27.
among the various financial sectors. "Managed competition" will not result in the competitive environment that the MOF supposedly sought to create. To facilitate competitive pressures that will lead to innovation, the MOF must let the market dictate entry. By preserving its ability to dictate who enters the market and when, the MOF is supplanting the market mechanism with administrative guidance.

In addition to regulating the number and timing of new entrants, the MOF has severely limited their scope of permissible operations, essentially splitting the securities industry into those companies that deal in bonds and those that deal in stocks. The banks' securities subsidiaries are strictly limited to dealing in corporate and government bonds: they are prohibited from handling equities. In effect, then, there will be no new entrants into the equity market and no effect on competition. This is exactly what the MOF intended. It specifically included this limitation to protect the smaller securities firms from any increase in competition. This slow change was very frustrating to the banks who wanted increased freedom for their securities subsidiaries to engage in a wider range of activities. Meanwhile, the securities subsidiaries are very anxious to enter the equity business as well. Unless the MOF allows the natural competitive market forces to operate, it will not see the innovation that it desires.

Since the new securities subsidiaries are limited to corporate bond underwriting, low bond prices could have a profound effect on the willingness of banks to establish subsidiaries when they do get MOF approval, slowing the process of reform. For instance, the first three securities subsidiaries had been doing well, benefiting from the strong bond market that lasted until late 1993, but they have begun to lose money since bond prices started to plunge in early January 1994. The MOF stipulated that subsidiaries must be profitable by 1997 in order to acquire approval, and with long-term interest rates on the rise since early 1994, making a

248. Rowley, supra note 229, at 6. Although limited in their activities, the securities subsidiaries have been active in those areas of operation permitted them. In February, 1994, IBJ Securities lead a syndicate of underwriters as lead manager for a ¥ 20 billion straight bond issue of Nissan Motor Co. Yuzo Saeki, Bank Securities Units Make 1st Bid to Underwrite Government Bonds, Nikkei Wkly., Apr. 11, 1994, at 13.


251. City Banks File Sweeping Deregulation Request, Jiji Press Ticker Service, Nov. 4, 1994, available in LEXIS, News Library, CURNWS File; Rika Otsuka, Japan Banks' Securities Arms Say Have Advantages, The Reuter Asia-Pac. Bus. Rep., Dec. 1, 1994, available in LEXIS, News Library, CURNWS File. Sanwa Securities president Toshiharu Ukegawa said, "We can't meet our clients' needs fully as long as we can't enter the equities business . . . . We want to be able to deal in equities as soon as possible." Id.

252. Inose, supra note 233. As of the end of September 1993, IBJ Securities posted ¥ 400 million (U.S. $3.8 million) of pretax profits and Norinchukin Securities posted ¥ 100 million (U.S. $950,000). LTCB Securities announced pretax losses of ¥ 100 million (U.S. $950,000). Id.

253. Ishibashi, supra note 212.
profit on bond trading will not be an easy feat.\textsuperscript{254} The difficulty in turning a profit by 1997 may deter banks from making the substantial investment in capital and trained personnel required to open a securities subsidiary.

The MOF has chosen to forbid banks who want to enter the securities business from purchasing existing securities houses.\textsuperscript{255} Banks that wish to have a securities subsidiary, therefore, must establish one themselves.\textsuperscript{256} This is expensive and difficult to do, especially when the subsidiaries' operations are limited only to dealing in unprofitable corporate and government bonds. This restriction will certainly limit the pool of banks with securities subsidiaries to those larger banks able to afford the expense of establishing a new subsidiary during an economic downturn. Therefore, there are fewer potential market participants and a lower degree of market competition.

Third, the greater the diversity of market participants' backgrounds, the greater the variety of innovations. Banks have the expertise, resources, and talent to make their subsidiaries competitive in the securities markets.\textsuperscript{257} But the large banks likely to be able to afford to establish new securities subsidiaries all serve large institutional clients. To the extent that they deal in the same businesses with the same type of customers, they all bring a similar background to the market. This similarity will decrease the variety of innovative products likely to be created in the coming years.

As a final consideration, with the Japanese economy in the grips of its worst recession in years, the reform hardly comes at an auspicious time. Many bankers are less than enthusiastic about the prospect of being allowed to compete in a stagnant securities market.\textsuperscript{258} Given the rapid decline in the bond market since January 1994,\textsuperscript{259} along with the current limit on the securities subsidiaries' area of activity, it seems likely that bankers will be cautious before investing in costly equipment, real estate, and personnel needed to establish a securities subsidiary. Thus, poor economic conditions will further slow the entry of additional participants into the market, again lessening competition and, therefore, the pressure to innovate.

\textsuperscript{254} \textit{Id.} (quoting Minoru Suzuki, president of Sakura Securities).
\textsuperscript{255} This is in contrast to the financial deregulation in London in 1986, known as the "Big Bang," in which commercial banks wanting to become members of the stock exchange were permitted to buy existing members. \textit{Japan's Big Bang. supra note 246.}
\textsuperscript{256} \textit{Id.} The MOF made an exception to this policy when it allowed Daiwa Bank to acquire Cosmo Securities in a bailout transaction in August 1993. \textit{See supra} note 229-30 and accompanying text.
\textsuperscript{258} See Fumiko Fujisaki, \textit{Japanese Reforms Don't Spell Free Competition,} The Reuters Bus. Rep., June 19, 1992, available in LEXIS, News Library, CURNWS File ("Even big securities houses are reluctant to establish new banking subsidiaries since they are increasingly cost-conscious after more than two years of stock market depression."); \textit{Japanese Savings: Safe as Post Offices,} ECONOMIST, Dec. 26, 1992, at 104 ("[Banks] are no longer in a hurry to enter the securities business, which is conspicuously unprofitable these days.").
\textsuperscript{259} \textit{See Inose, supra note 233.}
3. Comparison with the United States

The structure of the Japanese reform, which allows commercial banks and securities firms to enter one another's business areas through the operation of separated subsidiaries, is probably the best way to proceed. In a hearing regarding the repeal or substantial revision of the Glass-Steagall Act in America, Alan Greenspan, Chairman of the Federal Reserve Board of Governors, stated his belief that a section 20 subsidiary of a bank holding company, analogous to a Japanese separated subsidiary, is the best framework to allow banks to enter the securities field. Nevertheless, the implementation of the reform and the degree of discretion the MOF exercises in determining whether and when a bank subsidiary can enter the securities business leaves much to be desired from the standpoint of increasing competition.

It is true that in the United States, banks that want to establish section 20 subsidiaries have to apply to the Federal Reserve Board and have their applications approved on a case-by-case basis. In the context of the American system, however, this is completely reasonable. Commercial and investment banking in the United States were not separated by the Glass-Steagall Act to prevent competition between them or to cultivate an independent investment banking industry to protect the interests of the securities firms. The Glass-Steagall Act separated commercial and investment banking to protect the interests of depositors. Keeping this in mind, it is manifestly reasonable to expect that the Federal Reserve Board would scrutinize every application to protect depositors' interests. However, in the Japanese context, where the initial purpose of separation was to protect against competition, to dismantle a competitive restraint in such an anticompetitive manner only intensifies the result.

While it is perhaps true that a modest amount of reregulation is desirable to prevent economic turmoil, the MOF has absolute control over entry into the market. As long as the MOF gives banks the advantage of staged entry, they will not have to develop more efficient products and services to attract customers. Staged entry is acceptable to the extent necessary to avoid financial chaos, but it will make competition in the marketplace less fierce and thereby dampen the drive for innovation.

The primary factor that makes U.S. financial markets as innovative as they have been is not the structure of the U.S. financial system. A persuasive argument could be made that a different structure would lead to greater efficiencies and perhaps enhance innovation. The explanation for the high degree of financial innovation in the United States is the fact that financial firms in the United States face extremely fierce competition. In contrast, a major characteristic of Japanese finance ever since its incep-

260. See supra notes 118-130 and accompanying text.
263. See generally Macey, supra note 113.
tion in 1868 has been the predominant role played by negotiated rather than market transactions. Unlike the Japanese, whose private participation in the equity markets has been wholly lacking, Americans have always been very active in the equity markets. The Japanese have traditionally relied on banks for funding. Also, the U.S. banking market is the most open to foreign competition while Japanese markets are notoriously closed to foreign competition.

Structural similarity with the U.S. system will not give the Japanese financial system innovative drive. Only the degree of competition that the reform injects into the system will determine whether and what innovation will result. Even though the reform is better than the status quo, the implementation of the reform is misguided, since it softens the competitive blows to market participants. Nevertheless, there are several positive points to make regarding the reform.

4. Benefits of the Reform

Unquestionably, the changes that have been made are a positive step towards increasing competition in the Japanese financial markets. The new securities subsidiaries are intent on developing new products to compete more effectively against the established securities firms and against one another. The competitive pressure, however, may not be sufficient to stimulate enough innovation to become or to remain profitable. Regardless of how much competition the new financial system structure fosters and how much innovation this in turn produces, lowering the barrier between the banking and securities business will have definite benefits. Liberalization will allow the introduction of new, but not necessarily innovative, investment products, such as asset-backed securities, securitized loans, and money market funds, previously forbidden by the compartmentalized structure of Japan’s financial system.

264. See Cargill & Todd, supra note 21, at 49-50.
266. See Statement by John P. LaWare, supra note 32, at 32 n.32 (“The U.S. banking market, and U.S. financial markets more generally, are the most efficient, most innovative, and most sophisticated in the world. It is not a coincidence that our markets are also among the most open to foreign competition.”).
269. Emiko Terazono, Investment Innovations on Horizon in Japan, Fin. Times, Feb. 14, 1992, at 21 (“Growth of Japan’s asset-backed securities market has been stunted by Article 65 of the Securities and Exchange Act . . . .”). Institutional investors were reluctant to invest heavily in asset-backed securities because they were not categorized as securities. Id.
Another subtle benefit of allowing additional securities subsidiaries to enter the securities field may be the effect of attracting additional business to the Tokyo Stock Exchange, which suffers from low trading volume.\textsuperscript{270} Securities subsidiaries will give banks a stake in developing Japan’s stunted corporate bond market.\textsuperscript{271} In fact, when the securities subsidiaries of six large Japanese commercial banks entered the bond market on November 24, 1994, the morning volume doubled its usual levels, and bond traders welcomed them with open arms.\textsuperscript{272} The subsidiaries themselves hope to be able to expand the market overall, rather than merely stealing the established firms’ business.\textsuperscript{273} If they are able to expand participation in the capital markets, there will be more business to go around, and all competitors will benefit.

Established securities brokers fear that the subsidiaries will steal a great deal of their bond underwriting business by taking advantage of their parent banks’ strong ties with corporate clients.\textsuperscript{274} For example, in December 1994, Sakura Securities joined the underwriting syndicate for a ¥10 billion straight bond issue of Toho Gas Company—Sakura is the main bank of Toho Gas.\textsuperscript{275} Indeed, one high ranking officer of a Japanese tire manufacturer stated, “[W]e don’t want to upset our lead bank by turning down underwriting proposals from its securities unit ...”\textsuperscript{276} With the increasing trend of turning to capital markets rather than debt financing and the acceleration of asset securitization, it is likely that the keiretsu system will weaken as Japanese companies have less need to rely on a main bank to provide them with short-term credit. Nevertheless, for now, parent banks’ links to corporate Japan promise to be lucrative for their subsidiaries. Although the securities subsidiaries may have an advantage due to their parent banks’ corporate ties, that, in itself, would not be sufficient for the subsidiaries to grow and thrive. Sanwa Securities president Toshiharu Ukegawa stated that the subsidiaries are expected to come up


\textsuperscript{271} Japan’s Bankers Breach the Wall, ECONOMIST, Nov. 26, 1994, at 85.


\textsuperscript{275} Six More City Banks Establish Brokerage Subsidiaries in Japan, 63 Banking Rep. (BNA) No. 21, at 847 (Dec. 5, 1994) (“[O]ther bank brokerages are poised to seize on their main bank relationships with corporate clients ... for bond issues ...”).

\textsuperscript{276} Ishibashi, supra note 212.
with new ideas and good information services to serve their clients’ needs.\textsuperscript{277}

Conclusion
The goal of the Japanese reform was to increase competition. Yet, the MOF has introduced the reform in such a manner as to stifle competition and protect vested interests, specifically those of the smaller securities houses that rely on corporate stock trading for the main volume of their business. The smaller securities firms are the most likely to suffer dire consequences from the increased competition.\textsuperscript{278} But to the extent that jobs are lost by the failure of the smaller securities firms, this is simply a part of the natural process in a capitalistic system. Jobs displaced by modernization will allow people to seek jobs in areas of the economy where they are more needed and more productive.\textsuperscript{279} The MOF could have mitigated the loss of jobs in a less anticompetitive way—by allowing the banks to purchase existing securities concerns. The solution the MOF adopts, keeping the securities subsidiaries from operating in the equity markets, is only temporary. If the small securities firms are going to suffer from the increased competition of the banks’ securities subsidiaries, it is unclear why they will fare better under the competition with delayed entry. The MOF is only postponing the inevitable.

The trend in both the United States and Japan is toward integration of the commercial and investment banking business.\textsuperscript{280} Removing the barriers between them would bring both countries closer to the systems maintained in all other industrial nations and help the United States and Japan compete more effectively on an international level. While the large securities houses have benefited from the reforms,\textsuperscript{281} the banks have gained the most from the deregulation process.\textsuperscript{282} For any innovation in the next few years in Japan, we should look to the securities industry first. They have everything to lose and nothing to gain from relaxing the restraints imposed by Article 65; they had been competing effectively in the banks’ traditional markets before the reform and stealing the banks’ traditional loan business as consumers increasingly turned to the capital

\textsuperscript{277} Otsuka, supra note 251.
\textsuperscript{278} Japan’s Bankers Breach the Wall, ECONOMIS-r, Nov. 26, 1994, at 85.
\textsuperscript{280} As the Japanese begin implementing their weakened Article 65, the United States appears to be re-examining the wisdom of maintaining the separation between its banking and securities industries. See Tim Carrington, Glass-Steagall Act Targeted for Elimination, WALL ST. J., Feb. 27, 1995, at A2.
\textsuperscript{281} Nomura Securities, Daiwa Securities, Nikko Securities, and Yamaichi Securities, commonly known as the “Big Four,” established trust banking subsidiaries in October, 1993. Two-Way Openings, supra note 11, at 55. These subsidiaries allow the securities firms to engage in the foreign exchange business, and that is seen as a large advantage. Id.
\textsuperscript{282} Id.
markets for financing. The inroads the securities firms made into areas of traditional banking business was in fact one of the primary motivations for the reform.\textsuperscript{283} The securities industry has succeeded in convincing the MOF to keep the pace of the reform slow, allowing the banks only gradual access to the securities business. To combat the increased competition and their perceived disadvantage, the securities firms will have a greater incentive to innovate.

Frustrated with the degree of MOF control over the pace and substance of the reforms, critics have called the current financial reform a "bonsai" liberalization.\textsuperscript{284} These critics argue that the MOF is unwilling to allow competitive forces to reign in the Japanese financial system as they do in Western financial systems.\textsuperscript{285} It is for this reason, the lack of "Western-like" competition in the Japanese financial system, that the reform will probably not have the desired effect of promoting innovation to any significant degree.

Critics of the reform accuse the MOF of fearing change.\textsuperscript{286} New financial products and services created by Western banks and brokers are not available for use in Japan until they are cleared with the MOF individually.\textsuperscript{287} By that time, of course, all players in the financial markets are aware of the new instruments and know exactly how to use them, and nobody gains a competitive advantage over anyone else. For the Japanese to be more active in the creation of new and innovative financial products and services, they must introduce more competition between the various sectors of the financial markets than currently exists in their financial system. While the Financial System Reform Law is certainly a step in the right direction, it is really more of a half-step. Unfortunately, given the framework in which the MOF is implementing the reform, it is unlikely that we will see any real improvement for quite some time. The MOF said in April 1993 that it would review the regulations in two or three years,\textsuperscript{288} and perhaps by then it will be convinced of the benefits of competition. While some commentators are more optimistic about the reforms,\textsuperscript{289} it will take time before the advantages of staged entry produce any real innovation in the Japanese financial system.

\textsuperscript{283} See supra part II.B.3.
\textsuperscript{284} See Cargill & Todd, supra note 21, at 81 (The allusion refers to the Japanese art of forcing trees and shrubs to grow in a particular ornamental fashion by placing restrictions on the limbs so that they can only grow in the desired way.).
\textsuperscript{285} See id.
\textsuperscript{286} Holyoke, supra note 5, at 59.
\textsuperscript{287} Id.
\textsuperscript{288} Otsuka, supra note 253.
\textsuperscript{289} See Hirsh, supra note 246, at 26 ("There's a new type of competition in Japanese finance: for product innovation rather than just price or service.") (quoting Shoichi Royama, an Osaka University financial specialist who advises the government).