JAPAN

SECURITIES

SUMMARY

In the past, Japanese financial markets have been heavily regulated and compartmentalized with narrowly defined scopes of business for various financial service providers. Several developments over the past few years have helped to partially liberalize the markets, while holding out the promise for further deregulation and liberalization.

The U.S. Department of the Treasury and the Japanese Ministry of Finance (MOF) signed a bilateral Financial Services Agreement in February 1995, as a step in a 15-year series of ongoing discussions with the Japanese government on liberalization of financial services. Among other breakthroughs, this agreement provided for much-improved access by foreign investment advisory firms to Japan's massive pool of pension funds, liberalization in the packaging and sale of new securities products and derivatives, and the removal of many existing restrictions on cross-border capital transactions. Review meetings after the signing have generally found the government of Japan implementing the agreement faithfully, in some cases ahead of schedule.

Following the announcement of the "Big Bang" deregulation initiative by Prime Minister Hashimoto in November 1996, Treasury and MOF have also discussed its progress, prospects, and implementation during regular review meetings. As part of the "Big Bang," five advisory councils to MOF prepared reports recommending legal and regulatory changes to achieve "free, fair, and global" financial markets in Japan by 2001. The Japanese government has carried out most of the recommended measures scheduled to be implemented to date in the reports. Treasury will continue to monitor the implementation of this initiative as it is carried forward.

Many of the barriers identified in previous reports have been addressed by the 1995 agreement and deregulation under the "Big Bang" initiative. Remaining problems include the lack of freedom to offer new securities products due to a discretionary and time-consuming new product approval process, limited access to the domestic lead-underwriting business, and inadequate transparency of the regulatory process. Of particular concern has been the introduction in Japan of a Securities Investor Protection Fund, discussed in more detail below, which may have the effect of imposing extremely large liabilities on its members.

The stock market remains at a low level, in terms of both prices and volume, following the bursting of the asset-price bubble in the late 1980s. This has impacted the profitability of securities companies in Japan, and contributed to the failures during 1997 of the fourth and seventh largest Japanese securities firms and a number of smaller firms. More recently, world market volatility has caused some Japanese firms to lose substantial amounts in their international operations. Low stock market volume has also been attributed to lack of enthusiasm for stocks from individual investors, due to low returns and numerous scandals involving securities firms throughout the 1990s. Scandals last year, involving illegal payments to a racketeer, resulted in penalties – including fines, temporary suspensions of business, and management resignations – assessed on the three largest Japanese securities firms. Despite these problems, many of the U.S. securities firms in Japan have prospered, introducing business tie-ups with Japanese financial institutions or purchasing businesses and assets from Japanese firms, and expanding into new areas of business.

DESCRIPTION OF THE MARKET

Equity Markets

Japan has eight stock exchanges (Tokyo, Osaka, Nagoya, Kyoto, Hiroshima, Fukuoka, Niigata, and Sapporo), and an over-the-counter (OTC) system called Japan Automated Securities Dealers Quotation system (JASDAQ). Market capitalization of the Tokyo Stock Exchange (TSE) as of the end of 1997 was ¥280.9 trillion (US$2.2 trillion). At the end of 1997, there were 2,387 firms listed on Japanese stock exchanges. On the TSE, there were 1,805 domestic firms and 60 foreign firms listed.

Total volume for Japan's eight exchanges in 1997 was 130.7 billion shares, valued at ¥151.4 trillion (US$1.2 trillion). Of that total, the TSE accounted for 82 percent of the shares traded and 72 percent of the value of shares traded. The Nagoya and Osaka exchanges make up most of the rest of the volume, with the others combined totaling only 1.2 percent of shares traded and 2.2 percent of value. Over the counter, 1.46 billion shares of 847 companies were traded in 1997. This figure represents an increase over 1993 trading volume of 1.22 billion shares, but still well below the levels of the late 1980s. New equity financing by all listed companies in 1997, including rights offerings, public offerings, private placements, and exercise of warrants, totaled ¥939 billion (US$7.2 billion), down from ¥1,533 billion (US$13.2 billion) in 1996, but approximately equal to the 1994 total.

As of end-March 1998, financial institutions remained the largest holders of Japanese equities with 40 percent of the total. Banks held just over a quarter of all stocks, down only slightly from fiscal 1993. Non-financial corporations and individuals each held 24 percent, about the same ratio as at the end of fiscal 1993. Foreign shareholding of Japanese equities, however, rose markedly from 5.5 percent in March 1994 to 9.8 percent in March 1998.

Bond Markets

Japan has a large and active government bond market, as well as a developing corporate bond market that has expanded rapidly over the past few years. Total government and corporate bonds outstanding at the end of 1997 was ¥482 trillion (US$3.7 trillion), or 95 percent of Japanese GDP. During fiscal 1997, Japanese companies issued a record ¥8,800 billion (US$67.7 billion) of yen bonds, a 56 percent increase over the previous year. The Bond Underwriters Association reported that there were 557 corporate bond issues in fiscal 1997, up from 370 issues in fiscal 1996, and only 88 issues five years ago. In the first quarter of 1998, ¥4,300 billion (US$30.5 billion) of straight bonds were issued. Issuance of samurai bonds fell to ¥1,610 billion (US$12.4 billion) in fiscal 1997 from ¥3,800 billion (US$32.8 billion) in fiscal 1996, due primarily to recent currency swings.

Total outstanding corporate bonds, including bank debentures, as a percent of GDP was just over 26 percent at the end of 1997. Trading volume of bonds (domestic bonds and yen-denominated foreign bonds) on the TSE and OTC markets in Tokyo was ¥3,418 trillion (US$26.3 trillion) in 1997. Bank debentures account for roughly half of total outstanding corporate bonds, while straight corporate bonds account for another quarter. Convertible bonds, bonds with warrants, and yen-denominated foreign bonds make up the remainder.

The Japanese government amended its withholding tax laws for corporate bonds issued outside of Japan, including a safe harbor for corporate bonds held by non-Japanese. It is reported that the Japanese government is also considering amending its withholding tax laws for Japanese government bonds (JGBs), as well as other means to assist in making the JGB market more efficient.

Derivatives Markets

Japanese government bond (JGB) futures are traded on the TSE. The volume of trading has fallen over the past several years. One explanation is that, with the continuous rise in JGB prices in recent years, JGB futures trading has become more risky for those trying to engage in arbitrage (and indeed most trade for arbitrage rather than hedging). The number of 10-year JGB futures contracts, the most widely traded contracts, fell to under 12 million in 1997, after reaching just over 15 million in 1993. Futures on 20-year JGBs are also traded, although volume is quite small at only 2,167 contracts in 1997. Five-year JGB futures trading volume fell to 118,447 contracts in 1997, after 261,172 contracts were traded in the instruments' inaugural year in 1996. It is reported that the TSE is considering means to assist in making the JGB futures market more efficient.

Stock index futures are also traded in Japan. TOPIX (all stocks listed in the First Section of the TSE) futures are traded on the TSE while Nikkei 225 and Nikkei 300 futures are traded on the Osaka exchange. The number of TOPIX contracts has risen to just over 3 million in 1997, up from 2.6 million in 1994. In addition, TOPIX options and options on JGB futures are traded in relatively small quantities on the TSE. On the Osaka exchange, the volume of Nikkei 225 futures contracts rose from 6.2 million in 1994 to 7.5 million in 1997.

Individual stock options were introduced in July 1997 on both the Tokyo and Osaka exchanges. Trading on the limited number of issues available has been lighter than hoped, due in part to late announcement of the implementing regulations for the new product, as well as tax and regulatory disincentives. Only 70,896 contracts traded on 30 underlying stocks during 1997 on the TSE.

The Tokyo International Financial Futures Exchange (TIFFE) was established in 1989, initially with three products – futures on three-month Euroyen and Eurodollar interest rates and the yen/dollar exchange rate. Options on three-month Euroyen futures were launched in July 1991, while one-year Euroyen futures were launched in July 1992. However, trading is dominated by three-month Euroyen futures, while one-year Euroyen and three-month Eurodollar futures have not traded at all over the past year. Trading on TIFFE peaked in 1994 with annual turnover of over 40 million contracts, having risen sharply in 1993 and 1994. Annual turnover fell about 20 percent in 1995, before stabilizing at around 27 million contracts in 1996 and 1997.

Membership in TIFFE continues to decline from 216 members as of April 1994 to 180 members as of March 1998. Foreign membership has decreased slightly during the same period from 24 firms to 23 firms, of which 15 are clearing members and 10 are American firms. The U.S. firms are comprised of one bank and nine securities firms, the same composition as in 1994.

Investment Trusts and Pension Funds

Sales of investment trusts, Japanese mutual fund vehicles aimed primarily at retail investors, have been lackluster during this decade, given the poor performance of the stock market and scandals involving securities firms, the primary distributors of investment trusts, that have eroded investor confidence. Total net assets of stock investment trusts have declined after peaking in 1989, while total net assets of bond investment trusts have risen somewhat over the same period. At the end of 1997, total net assets of stock investment trusts totaled ¥9.9 trillion (US$76 billion), while those of bond investment trusts totaled ¥30.7 trillion (US$236 billion). This compares to total net assets of stock and bond funds at the end of 1994 of ¥17.5 trillion (US$175 billion) and ¥26.0 trillion (US$260 billion), respectively.

The pension fund market has continued to expand. At the end of March 1998, corporate pension money in Employee Pension Funds (EPFs) and Tax Qualified Pension Plans (TQPs) totaled ¥48.7 trillion (US$345 billion) and ¥19.2 trillion (US$140 billion) respectively, representing an increase in corporate pension funds of over 30 percent (in yen terms) since March 1994. The assets of the Pension Welfare Public Corporation (Nempuku), which manages a portion of the public sector pension assets, reached ¥22.6 trillion (US$161 billion) at the end of March 1997.

Market Regulation

Until recently, regulation of securities companies was carried out by the Securities Bureau of the MOF and the Securities Exchange Surveillance Commission (SESC). Beginning June 22, 1998, a new Financial Supervisory Agency (FSA) was created to supervise banks, securities firms, and insurance companies. The FSA has initially been staffed primarily with regulators drawn from the Banking and Securities Bureaus of the Ministry of Finance (MOF). While policy planning will remain with the MOF, supervision and regulatory enforcement will reside with the FSA.

The securities industry is also governed by the Japan Securities Dealers' Association (JSDA), which serves as a self-regulatory body, under the oversight of the MOF. The JSDA also administers the OTC market. All securities firms, including foreign firms, are required to be members of the JSDA, and there is foreign participation on the Board of Directors. Similarly, the Japan Securities Investment Advisors Association (JSIAA) and the Japan Investment Trust Association (JITA) have compulsory membership and act as self-regulatory organizations for investment advisors and investment trust managers, respectively.

The Securities and Exchange Law (SEL) defines the securities business and securities products and reserves these areas specifically for securities firms. Participation in each of the four major securities activities – dealing, brokering, underwriting, and distribution – requires licenses from MOF, although the licensing system will be changed to a registration system as of December 1, 1998. Specific lines of business identified as "high-risk," such as underwriting and OTC derivatives, will continue to require approval from the regulator. Other types of businesses have been allowed for securities companies under a positive side business list, defined under the SEL.

Specific changes to be implemented under the "Big Bang" initiative include the change to the registration system mentioned above, the expansion of primary securities business activities, as well as side businesses, deregulation of brokerage commissions in two phases, a review of securities-related taxes, reform of regulations for the domestic mutual fund industry and the sale of offshore funds in Japan, and elimination of barriers between securities and banking activities. As a result of the last item, securities subsidiaries of banks will be allowed to engage in the full range of securities businesses, including the sale of mutual funds. At present, banks' securities subsidiaries can only deal in fixed income products. Following the revision of the Foreign Exchange Law, effective April 1998, MOF also revised the regulations governing securities firms to allow a broader scope of foreign exchange activities.

In reaction to the failure of securities firms in the fall of 1997, the authorities are planning to augment funds available to protect investors by introducing an expanded mechanism called the Securities Investor Protection Fund (SIPF) on December 1, 1998. The new Fund will draw together existing investor protection mechanisms and add to those funds with mandatory contributions from all securities firms. After three years of collections, it is anticipated that the SIPF will contain ¥50 billion (US$355 million). A formula for assessing these contributions has not yet been decided. The SIPF is to cover all cash deposits and other assets of non-institutional investors held by securities firms until March 2001, in keeping with the Japanese government's pledge related to bank deposits. After that time, a ceiling amount per investor will be imposed. Although the law requires all securities companies to be members of an insurance fund as of December 1, 1998, new segregation rules expanding the scope of customer securities required to be separated from proprietary accounts will not be implemented until April 1, 1999. Combined with the unlimited coverage per customer account until March 2001, this gap will impose an uncertain, and potentially extremely large, liability on the members of the new SIPF. Foreign securities firms, in particular, have requested that

Fund members should meet minimum capital adequacy and asset segregation standards before joining in order to limit the responsibility of solvent members of the Fund for financially troubled firms that may not have segregated customer assets from their own.

TIFFE is regulated by the FSA. The impact of the "Big Bang" on futures includes changes in law and exchange rule tot improve the regulatory structure with respect to segregation of customer funds, default, insolvency, and risk disclosure. There will also be more flexibility to offer products through various intermediaries and a phase-out of fixed commissions.

Foreign Portfolio Investment

There are no quantitative restrictions on inward portfolio investment to Japan, although some restrictions by industry based on national security concerns do exist for direct investment. In addition, corporate practices like cross-shareholding limit the percentage of shares in individual firms and in the overall market that foreign investors can actually purchase, while informal restrictions on management participation by foreign shareholders limit the attractiveness of Japan's equity market to foreign investors.

The ability of Japanese nationals to invest offshore was facilitated by the implementation of the revised Foreign Exchange Law on April 1, 1998. The revision of this law removed restrictions on resident overseas deposits and eliminated prior notice requirements on foreign portfolio investment, although ex post reporting requirements remain, while allowing a much broader range of participants (in addition to banks in Japan) to conduct foreign exchange business. The "authorized foreign exchange bank system" has been dismantled, and the principal requirement that Japanese residents buy or sell foreign means of payments from or to an authorized bank or licensed exchange broker in Japan, has been lifted. In conjunction with these changes, MOF issued an administrative notice effective March 31 to expand the scope of foreign exchange activities allowed for securities firms, which appears to respond to industry requests.

U.S. PRESENCE IN THE MARKET

At the end of 1997, there were 290 licensed securities companies in Japan, with 183 of them holding licenses for the full range of securities businesses. Of those, 58 are foreign firms with 69 branches in Japan. Twenty-two U.S. securities firms have 28 branches in Japan. This compares with 48 foreign branches, of which 18 were American, in 1994. In addition, 60 foreign securities firms, of which 9 are U.S. firms, have representative offices in Japan. This total is down from 92 foreign representative offices, and 14 American representative offices in 1994.

In 1997, foreign firms expanded their share of equity trading volume, with U.S. firms becoming the top three volume traders at times, in part as a result of the disciplinary actions resulting in trading suspensions of several large Japanese firms. Some foreign firms are making record profits, and many are expanding their operations in Japan in response to expected opportunities afforded by the "Big Bang" deregulation. After concentrating for many years on institutional clients, a few U.S. firms are introducing retail operations in Japan, either through acquisitions of the retail businesses of Japanese firms or business tie-ups. In addition, foreign firms are greatly expanding their operations in asset management, both in the pension fund and mutual fund areas, following the expansion of access under the 1995 Framework Financial Services Agreement.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

There are no serious instances of denial of national treatment to U.S. securities, investment management or investment advisory firms. However, some regulations hinder the ability of U.S. financial firms to fully participate in and provide services to Japanese market participants. An example is the cumbersome new product approval process for securities products, which limits the ability of U.S. firms to exploit their competitive advantage in innovative products. In addition, although there have been signs of improvement, the lack of transparency in the formation of new regulations and the lack of a public comment period for proposed regulatory changes limit the possibility for formal consultation with the regulatory authorities.

Entry and Establishment

As noted above, entry and establishment of securities firms are regulated by the SEL. As part of the "Big Bang" deregulation initiative, the license system for securities firms is to be replaced with a registration system that will allow firms to open business after registering with the FSA, subject to certain rules, including minimum capital requirements. Approval to undertake certain "high-risk" lines of business will still be required. These changes are slated to take place on December 1, 1998.

Foreign firms are also governed by the Foreign Securities Companies Law, which requires that individual foreign securities branches be treated as independent of each other. Thus, each branch must seek separate licenses and be separately capitalized. This law will also be amended as of December 1, so that all branches of a single foreign firm will be treated as a unit, and will fall under the registration, rather than licensing, system.

Investment Trust Management

Numerous changes have occurred over the past several years providing for more meaningful access for foreign investment advisory and investment trust management firms. The 1995 Framework Financial Services Agreement provided for simplified entry by allowing a single firm to hold both investment advisory and investment trust licenses, and expanded the scope of funds that could be managed by investment advisory companies to include the Pension Welfare Service Corporation

(Nempuku), and other public and corporate pension funds. In addition, asset allocation guidelines for pension funds are being phased out, providing more flexibility for fund management and enhancing the competitiveness of foreign fund managers. These changes resulted in a drastic expansion of assets under management by foreign investment advisory and investment management firms (albeit from a very small base). All investment advisors, including Japanese and foreign firms, increased pension funds under management by 42.9 percent in 1997. As of the end of September 1998, investment trust assets managed by all foreign firms rose above a 10 percent share for the first time, despite a decline in overall net assets managed in this sector. Also, in fiscal 1997 alone, foreign trust banks' combined corporate pension fund management nearly doubled, rising 98 percent, while assets under management by Japanese trust banks increased only 4 percent.

As part of the "Big Bang" initiative, distribution of investment trust products will also become less restricted. In the past, only sales through securities firms or costly direct marketing were allowed. As such, foreign firms without extensive retail presence in Japan were at a disadvantage. Beginning in December 1997, investment trust companies were allowed to rent space within bank branches to sell their products, and from December 1998, banks will be allowed to sell investment trust products directly on behalf of investment trust firms. Also from December 1998, investment trust managers will be able to delegate authority to sub-advisers, enabling foreign-based firms to use their overseas affiliates to make use of global investment capacity. Regulations permitting the sale of offshore funds in Japan are also being streamlined.

Underwriting Corporate Securities Issues

Until very recently, restrictions on the types of corporate securities that could be issued, their interest rate structures, eligibility requirements for issuers, new product approval requirements, and the dominant role played by the largest Japanese securities firms prevented much activity by foreign firms in underwriting corporate securities. Regulatory changes over the past few years have significantly loosened these restrictions, and foreign firms are beginning to have more success in this area, although activity is still quite limited. In June 1998, a U.S. firm was the lead manager of the largest domestic bond issue ever managed by a single foreign firm, a ¥50 billion (US$355 million) issue. This was the first corporate issue of straight bonds of significant size managed by a single foreign firm. However, this success represents a small beginning as the foreign share of lead management rose from only 0.7 percent in fiscal 1996 to 2.8 percent in fiscal 1997.

FINANCIAL MARKET DISCUSSIONS

As Japan's current regime of securities regulation is commensurate with its GATS commitments, the focus in Japan is less on the denial of national treatment than on deregulation.

Under the U.S.-Japan Framework for a New Economic Partnership ("the Framework"), the U.S. Department of the Treasury and MOF signed a bilateral Financial Services Agreement in February 1995, as the latest step in a 15-year series of discussions with the Japanese government on liberalization of financial services. Among other breakthroughs, this agreement provided for much-improved access by foreign investment advisory firms to Japan's massive pool of pension funds, liberalization in the packaging and sale of new securities products and derivatives, and the removal of many existing restrictions on cross-border capital transactions. Review meetings after the signing have generally found the government of Japan implementing the agreement faithfully, in some cases ahead of schedule.

On November 11, 1996, Prime Minister Ryutaro Hashimoto announced that his government would undertake sweeping deregulation of Japan's financial system by 2001, an initiative dubbed the "Big Bang". The goal is to make Japan's financial market comparable with those of London and New York by utilizing the three guiding principles of "free, fair, and global" to achieve widespread deregulation. Five government advisory councils – the Committee on Foreign Exchange, the Business Accounting Council, the Securities and Exchange Council, the Financial System Research Council and the Insurance Council – produced recommendations in June 1997 for specific measures to carry out the "Big Bang" objectives. In the spring of 1998, a package of legislation to implement a large number of these deregulation measures was submitted to the Diet, and final approval was received in early June. Implementation of the bulk of the measures will occur on December 1, 1998. Treasury will continue to monitor the progress of this initiative within the context of regular financial services consultations with MOF.

In June 1997, also under the auspices of the Framework, the governments of the United States and Japan engaged in a new dialogue called the U.S.-Japan Enhanced Initiative on Deregulation and Competition Policy. Under the Enhanced Initiative, meetings of high-level officials and five expert-level groups covering telecommunications, housing, medical devices/pharmaceuticals, financial services, and deregulation/competition policy have been conducted over the past year. Discussions for the financial services group have been held in tandem with the review meetings mentioned above and have covered the deregulation efforts being made by the Japanese government under the "Big Bang" initiative.

Exchange Rates Used:

1994	100 ¥/US$
1995	103 ¥/US$
1996	116 ¥/US$
1997	130 ¥/US$
1998	141 ¥/US$