

DOKUMENTATION

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Summary of Discussions Securities and Exchange Council, General Committee

November 29, 1996

INTRODUCTION

The General Committee of Securities and Exchange Council, chaired by Prof. *Shoichi Royama* at Osaka University, has discussed what reforms should be made in the Japanese securities market over the mid-term in preparation for the coming of the 21st century.

So far, we have mainly discussed problems with the Japanese securities market, basic ideas, proposed reforms, and the direction that market reforms should take. "Summary of Discussions" summarizes our discussion to date concerning such matters, and constitutes a discussion framework for the Committee to examine concrete matters.

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I. STATUS QUO AND PROBLEMS IN JAPANESE SECURITIES MARKET

1. The question of what form the Japanese securities market ought to take has now risen to the fore. The market has developed along with the Japanese economy, and it has played an important role in the economy. As a result of changes in economic and social environment, however, people expect more of the securities market. Can the market answer such expectations? The securities market as a whole is required to execute reforms over the medium term looking to the 21st century, rather than focusing upon the vitalization of present market transactions.

2. The Japanese financial and capital market has emphasized the role of distributing funds effectively and in concentration to key industries. The market, however, has entered a stage where the emphasis should be changed. As the percentage of elderly persons within the general population increases, individual financial assets now total as much as 1,200 trillion yen. Financial and capital markets now have to work to ensure that assets are invested more effectively. At the same time, the maturation of the economy has made it more important to provide funds to various new industries comprising positive risk burden in funding. In addition, because of the huge accumulation of financial assets in Japan, the Japanese market now has to play a greater role in the effective distribution of funds from a global point of view.

3. Such a role cannot be fulfilled under the traditional Japanese system of indirect financing based upon bank loans and deposits. It is assumed that the securities market, which could effectively perform the functions of risk management and distribution, could satisfy financial intermediary needs of the new era. Today's Japanese securities market, however, is far from such a desirable condition. In other words, deposits and savings continue to account for far larger share of financial assets than that of the vastly smaller share accounted for by individuals investors. Borrowing continues to play an important role in business funding. In addition, participation by overseas investors and companies in the Japanese market is restricted.

4. The major causes of such problems do not lie in the history of economic development or Japanese culture. Instead, these problems may be attributed to the framework of the securities market and the attitudes of the people who work there. There is criticism that both the legal and the administrative frameworks for regulating the securities market have served as to hinder market professionals from exercising originality and assuming responsibility. It has also been pointed out that the accounting, taxation, and legal systems that constitute the market infrastructure, unlike those in other major financial centers, have not been designed to promote product development or transactions. Those who comprise the market have behaved themselves in accordance with economic rationality under the framework of preventive regulations and the existing system infrastructure, which has made the market what it is today. The following problems have surfaced, however, due to changes in environment of the Japanese securities market.

- (1) As for securities exchanges and the over-the-counter market, it may be necessary to reduce the various transaction costs to be paid by users and make transaction services more attractive and convenient for users in accordance with their changing needs.
- (2) Intermediaries (securities companies and asset management companies) may not have made sufficient efforts to provide unique and original services. They may be able to encourage investors to utilize the securities market more actively, by marketing attitudes that attach more importance to the views of investors.
- (3) May individual investors have partially pursued short-term capital gains or not fully understood the principle of self-responsibility? It may be necessary to make the principle of self-responsibility generally known. It may also be necessary to increase the investor base by transforming the securities market into something that the average person can more easily understand and by creating a climate that allows long-term stock holding.
- (4) The ability of institutional investors and fund managers to manage assets is now being called into question. Furthermore, the attitudes of these institutional investors and fund managers which lead them to follow the lead of others may have impeded the offering of a variety of unique products. This may be one of the factors hindering smooth price formation in the market.
- (5) Issuing companies may be required to adopt an attitude towards marketing that attaches greater importance to stockholders and investors. It is important that the issuing of security faithfully reflect the market conditions, performance of the company and its rating. Issuing companies may need to consider these matters more fully.

Mutual holding of stocks by companies and banks based on non-financial motives is economically reasonable in the traditional framework. Such activities, however, affect stock

price formation, creating doubts as to the market value of stocks as financial assets and corporate governance. This, as a consequence, may have negatively affected the willingness of real investors, including individuals, to invest in stocks.

5. Globalization of the economy and finance and the advances in telecommunications and information technologies have freed capital transactions from geographical and physical restrictions, creating new possibilities. At the same time, such changes have intensified international competition in pursuit of lower costs and higher added value. International competition between markets makes it possible for the need for the procurement and management of funds to be satisfied in overseas markets. The Japanese securities market, however, must not be de-industrialized because it is difficult for individuals and small companies to obtain direct access to overseas markets, and the deindustrialization of the industry might impede the availability of information on finance and securities transactions and lead to unemployment in the financial and securities industries. To make the market a convenient, attractive, and competitive one that satisfies international standards will contribute to effective investment of abundant Japanese financial assets in the Japanese market and the development and growth of new industries.

6. Problems with the Japanese securities market arise from a wide variety of causes. To allow the future securities market to meet the needs of the people in the 21st century, it will be necessary to introduce drastic and comprehensive reforms. Such reforms should start with the transformation of the traditional framework of regulations, including administration, which should be followed by changes in the awareness and behavior of market users, intermediaries and operators.

7. The securities market is a common asset of the people. The climate which makes people look askance upon stockholders conflicts with the essence of the securities market. This view of the securities market and the problems surrounding it make it difficult to tell what are the causes and what are the results of problems. In any case, it is desirable that everyone concerned should endeavor to cultivate the securities market as an important national asset. Accordingly, efforts should be made in terms of reforms to revitalize the market and to make it easier for the average person to utilize. At the same time, care must be taken not to harm benefits to not only direct users but also people at large by unfair practices or conflicts of interest. We must always remain aware that it is the nation as a whole which is the final beneficiary of the market.

II. OBJECTIVES AND PROCEDURE OF REFORMS

1. *Objectives of Reforms*

When the above facts are recognized, it is evident which direction the reformation of the Japanese securities market should follow. Reforms should be enacted to realize the following five objectives to enhance the attractiveness of the Japanese market.

(1) Making the securities market the main financial intermediary

Efforts should be made to transform the market into an attractive and effective one which, as the center of financial intermediation, can answer the needs of the now-mature economy for the formation of national financial assets and appropriate distribution of funds. The securities market must provide a wide variety of attractive, valuable products to satisfy the needs of investors for asset management and to promote smooth funding by active risk taking. If the market adequately fulfills such positive roles and functions, it can contribute to maintaining a durable vitality in the national economy.

(2) Restoring the Tokyo market

Efforts should be made to make the Tokyo market a competitive, international one able to stand shoulder to shoulder with those in New York and London as one of the three largest

financial centers in the world. The Japanese financial industry must not be allowed to become an empty shell. To that end, it is necessary to establish an infrastructure capable of satisfying the international standards and reducing transaction costs. At the same time, the market should be transformed in accordance with international rules and practices. Such efforts will make the Japanese market internationally useful and capable of contributing to the effective distribution of global funds.

(3) Establishing a framework capable of continuing to function in the 21st century

Efforts should be made in light of the approaching 21st century to create a world-leading market where market intermediaries can play an active part. If Japanese financial and investment services are revitalized through the activities of internationally competitive, efficient, and innovative market intermediaries that have an entrepreneurial spirit, and if high-quality services are provided at a low cost, employment in the financial and investment industries, mainly the securities industry, will be ensured in the 21st century. In addition, such revitalization would contribute to the maintenance and promotion of competitiveness of other Japanese industries utilizing these services.

(4) Making the market an open one

Efforts should be made to make the market a user-oriented one which is open to the people and which allows a variety of people and companies to freely participate and enjoy its benefits. Active utilization of the market by a large number and variety of market participants in accordance with respective needs would vitalize the market.

(5) Making the market fair, transparent, and reliable

Efforts should be made to create a reliable market where users can willingly participate regardless of their standpoints, backgrounds, or ability. For that, the principle of self-responsibility must be observed by every market participant. In accordance with this principle, the market must be transparent, reliable and fair, based upon clear rules, and it must be obvious and certain to everyone that none will suffer unfair disadvantages because of reasons not attributable to themselves. From this viewpoint, the public feature of market intermediaries to guarantee access by individual investors to the market must be adequately secured.

2. *Implementation of reforms*

(1) Reforms to create such a market must be able to fundamentally change the condition of the market and be conducted in a comprehensive manner so as to cover different aspects of the market. The framework of market regulations and system infrastructure must be reformed. In addition, market professionals should try to solve problems one by one from their own standpoints in light of the current market conditions mentioned earlier and do whatever they can to reform the market.

(2) Because specific issues requiring reform are mutually related, reforms must be conducted in a comprehensive manner. Therefore, it is necessary to clearly present the procedures by which reforms are to be implemented, including time frames if possible, for the implementation of these reforms. In addition, it is extremely difficult to revitalize an industry once it has lost its power and influence. Therefore, such reforms need to be conducted immediately. Because of the urgency of reforms, we should strive to complete most of them by the beginning of the 21st century, paying attention to the stability of the market as well as other matters.

(3) It goes without saying that in the implementation of reforms designed to create improved market conditions, it is essential at the same time to tackle problems presently faced by the financial and capital markets due to the collapse of the bubble economy. Such problems include the disposition of non-performing loans.

III. SPECIFIC REFORMS

To create a desirable market, which we should strive to do, specific reforms must be implemented regarding products to receive investment, the market to balance demand and supply, intermediaries to provide asset investment transaction services, and administration to guarantee fair, effective, and competitive transactions. Because of the nature of the objectives of reform, such measures will be based upon the following principles.

Variety of Choice

Reforms to expand the possibilities of the market. The expansion of possibilities of the market to answer diversified user needs would improve convenience for market users, thus making the market more profound.

Attractive to users

Reforms to enhance the attraction and competitiveness of the Japanese market and intermediaries through providing innovative products and services that have high added value, or that can minutely and appropriately answer needs of customers. The enhancement of the attractiveness and competitiveness of products and services would make the Japanese market a competitive one which would attract both domestic and overseas users and which would be a worthwhile place of investment.

Fair and reliable market

Reforms to make the principle of self-responsibility followed by every market participant and enhance the reliability of the market under clear and transparent rules. In government administration, the idea that investors should be shielded from risk should be abandoned. Instead, emphasis should be placed upon making the risk involved in investment known to individual investors. The creation of a fair and reliable market would restore people's confidence in securities investment and make securities investment closer to the people.

In view of the above fundamental principles, it seems necessary to consider such matters as transformation of the regulatory framework including the administration, which covers products, the market, and intermediaries. To restore the Japanese securities market in light of the 21st century, it is necessary to tackle these problems in a comprehensive manner. The General Committee, as a matter of course, will further discuss the respective problems. The Committee, at the same time, hopes that other people concerned will also deal spontaneously and positively with them.

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Comprehensive Reform of the Securities Market: For a Rich and Diverse 21st Century The Securities and Exchange Council

13 June 1997

I. BACKGROUND AND OBJECTIVES

Dynamic innovations in communications, information and financial technologies, together with globalization of capital markets, have freed financial transactions from physical and geographical constraints, and have dramatically enhanced the functioning of capital markets. This in turn has resulted in improved investment opportunities, even at the household level, and in greater flow of funds to emerging industries, thus playing an important role in helping industrial economies regain their dynamism.

With a rapid aging of the population, Japan needs to raise the return on the 1200 trillion Yen of household financial assets. Ensuring an adequate source of capital for the next generation of key industries is an important goal. As an economy that generates a significant portion of global savings, Japan also needs to meet its international responsibility by ensuring that these savings are channeled effectively to the rest of the world, including to developing countries.

The financial system needs to function efficiently if these objectives are to be met. The role of the securities market is particularly important, as the market is uniquely suited for risk-taking and risk-diversification.

Globally, there have been large reforms in securities markets around the world. By contrast, in Japan, in the boom-and-bust of the financial bubble during the past decade, innovation in the securities market had slowed. As a result, the market is not living up to its full potential, so that the possible hollowing out of the Japanese market is a source of concern. There is an urgent need to make the Japanese market more attractive and competitive internationally, to reconstruct a dynamic capital market, and thereby to allow investors and issuers to enjoy the full benefits of an advanced capital market.

Without a radical and comprehensive reform of the securities market, the Japanese securities market has little prospect of becoming an attractive, international market, and will ultimately put Japan's economic growth and a wider international acceptance of the yen at risk.

The comprehensive revision of the Foreign Exchange Law enacted in May, provides Japanese investors and firms the freedom of access to markets worldwide, and is a front-runner in the overall reform of the financial system. With this foreign exchange liberalization, Japanese markets will be truly integrated into the global market. This in mind, the reform of the securities market aims to place the Japanese market on par with major financial markets worldwide, by ensuring that the Japanese market can freely generate and employ innovations in financial instruments and transactions. The reform also needs to make every effort to make the market as fair and transparent as possible, so that domestic retail investors and foreign users of the Japanese market may approach the market with confidence. Furthermore, the reform must also increase the freedom of Japanese intermediaries, so that they may offer better services and compete effectively in the global marketplace.

II. BASIC DIRECTION OF REFORM

The task of this Council is to propose how such a restructuring of the Japanese market may be accomplished.

1. From gradual deregulation to structural market reform

Fundamental reforms in many markets around the world have left the Japanese market lagging seriously behind the most advanced markets. In order to recoup this delay, an urgent task is to introduce those products and services that are commonplace in overseas markets but have not yet been introduced in the Japanese market. However, the Japanese market cannot become an international market rivaling New York and London, if Japan only introduced products after they had been developed in overseas markets. Not only will it be necessary to close the gap with more advanced markets, but it should be the aim of this reform to build a mechanism into the market by which the market develops spontaneously.

In Japan, there has been a tendency to introduce new instruments and services on a one-by-one basis: typically, an instrument or a service that had been developed in overseas markets will be identified; its domestic market potential and investor protection measures studied; and after a consensus on desirability had been reached, the new instrument or service will be introduced under a common industry standard. Such a strategy was efficient in the sense that it eliminated trial-and-error process by introducing only those

instruments and services with a proven track record. However it not only limited the scope of options available to investors and issuers, but may also have encouraged an imitative attitude among financial intermediaries and discouraged creativity. Similarly, an approach that placed emphasis on distancing investors from risk rather than making risk known to investors, may paradoxically have created the misperception that those areas where restrictions had been lifted were safe areas with an official seal of approval, thereby weakening the idea that each market participant is responsible for his own judgment and must behave in the market with self-discipline.

If the Japanese market is to develop in step with the global market in an age of rapid financial innovation, an approach whereby regulators vet and approve each new instrument or service is not a viable strategy. Rather, regulations that act to restrict new initiatives should be reduced to the extent possible, and creativity be allowed to flourish. To this end, preventive regulations limiting activity and products should be repealed to the extent possible, and policies should shift to one that builds up an environment in which market discipline operates effectively. Investors and firms should be given the freedom to choose from as wide a range of financial instruments and services as possible, basing their decisions on accurate disclosure of information. Through this process, those instruments and services that best meet the needs of the users will be born and will grow. Building a framework that encourages such development of the market based on market forces is the key to enhancing the quality and competitiveness of the Japanese securities market, and, ultimately, in regenerating dynamism on the Japanese economy, as well as ensuring a more efficient allocations of resources worldwide.

The Council proposes to move from a regime that is based on a single, unified system to one that encourages diverse competition. It also asserts a shift in supervision policy from one that attempts to regulate business activity to one that is centered on disciplinary powers of the market. Similar ideas have underscored past market reforms in the United States and in the United Kingdom, and is most probably a natural response to the increased sophistication of financial and communications technology, and globalization of financial markets. It should be noted that the reforms in these two countries have helped create employment and income growth in the securities industry, and have enhanced the global position of the New York and London markets.

The Japanese market has, underlying it, 1200 trillion Yen of household financial assets, a huge real economy, and financial intermediaries with high potential for innovation. The Japanese market, then, has the ingredients to become a truly international market. By creating an infrastructure that encourages innovation based on market principles, and thereby transforming the market into one where intermediaries with advanced financial technology and flexibility to meet diverse needs can flourish, the Japanese market could become an internationally recognized market that can be compared to New York and London.

2. *The Importance of Market Framework*

(1) Building a Fair and Trusted Market

A reorientation of regulatory philosophy towards one that emphasizes freedom of activity will increase the importance of creating a market that is fair and can be trusted. A free market should not degenerate into a wild west where self-interest simply collide with one another. Fair competition must prevail in order for the market mechanism to function effectively. To this end, the market must be such that ordinary investors, who are the holders of the 1200 trillion Yen of financial assets and who are in a disadvantaged position in terms of access to information and negotiating ability, can participate in the market without the apprehension that he may be treated unfairly. If this were not the case, then it would be impossible to require investors to evaluate risk and form their own investment decision. Moreover, in an internationally open market, clear and transparent rules and their swift and effective enforcement are necessary for transactions between professional market participants.

A sense of trust that fair transaction rules are universally observed is the most basic requirement for a market. Such a goal cannot be achieved through the traditional approach of ensuring the soundness of the market by regulating the business activity of intermediaries, given that the proposed reform intends to create a framework in which market mechanism is to drive market development. A transition from preventive regulation to rule-based surveillance, and in particular strengthening of disclosure, fair transaction rules, and surveillance and enforcement mechanism are essential. Although such a penalty based system provides an underpinning for the market, it will not be enough to rely on criminal penalties alone. A system of dispute settlement whereby compensation for financial injuries from unlawful and unjust actions are quickly and reliably recovered is also important. In addition to penal and administrative penalties, the existence of such a civil procedure will also be an effective deterrent to unfair market activity.

Nonetheless, market cannot exist solely on the basis of a system of rules that can be ultimately be resolved through a judicial or administrative process. Observing established rules is a minimum requirement. As the scope of freedom widens, market participants will be required to regulate themselves in a disciplined manner. In the case of disclosure, for example, it is not enough simply to disclose information required by law: issuers should actively disclose information that may be of value in forming investment decisions, and do so in an easily understood fashion. This is important not only for the market, but it is ultimately in the interest of the issuer himself, as those that do not disclose sufficient information will eventually be shunned by investors.

Irresponsible actions will destroy the market, and in the long run, is not in the interest of the participants that behave in such a manner. Freedom requires a higher ethical standard. It is an important challenge for the Japanese market to firmly establish a high standard of ethics in the market. Those involved in the securities market should make every effort to strengthen the Japanese people's trust in the market.

(2) Developing Market Infrastructure

The other important role for the public sector, along with the establishment of rules, is to improve market infrastructure such as the settlement system.

Recent advances in technology mean that private supply of services is feasible even in areas where it was taken for granted that the service had to be provided by the public sector. It is appropriate for the private sector to take the lead in areas where it is feasible to do so.

It is also important for the public sector to complement private initiatives, if leaving it entirely to the private sector could result in an undersupply or inefficient supply of services. Care must be taken, of course, so that official involvement does not kill off the emergence of alternative sources of supply by constraining the development of market infrastructure into a single mold.

Civil and Commercial Codes, as well as the Tax Code and the Accounting Standards are all important elements of market infrastructure and comprise what may be considered a system of basic software. As deregulation proceeds and improvements in the market's physical infrastructure such as the settlement system take place, the market will gradually converge towards a common global standard. In that process, the market-friendliness of such basic software is emerging as a factor that determines how user-friendly a market is. With globalization of financial markets, users can increasingly even select between different systems of basic rules, by choosing the market in which a transaction takes places. As a result, for financial transactions, there is now emerging a set of de-facto standard for Civil, Commercial and Tax Codes as well as Accounting Rules. A market whose rules differ significantly from such a standard risks being bypassed by users, particularly professional ones.

III. A PLAN TO REFORM THE SECURITIES MARKET

1. *The Scope and Schedule of the Reform*

The problems that the Japanese securities market need to overcome are rooted in wide-ranging factors. Rather than considering them individually, the reform effort must be a comprehensive one that reformulates the market framework in a manner that encourages development that is guided by market forces.

The importance of reorientation of regulatory philosophy and building of market infrastructure cannot be overstated, but it is equally important to recognize that these cannot be panacea. Rather, one should consider restructuring of the market framework as a starting point, from which users, intermediaries and operators of the market must all strive to tackle the tasks that they face. The reform of the securities market is a comprehensive package of program and efforts that encompasses all market participants.

The Securities and Exchange Council proposes a reform package outlined below.

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IV. DETAILS OF THE REFORM PLAN

Outlined below are the individual items of the reform package, together with the considerations that led to these recommendation, classified according to three broad areas of products, markets and intermediaries. Further details may be found in the annexed reports by the three Working Parties that looked into these three areas.

1. *Investment Vehicles (Attractive investment instruments)*

(1) Introduction

A system that allows the supply of a variety of investment vehicles must be put into place, so that varied and complex requirements of investors can be met. This will also help enhance the vitality of firms, as it widens the options available for fund raising. A framework supporting diversity in financial products is a fundamental precondition for market revitalization.

(2) Framework for encouraging diverse products

The basic approach should be to eliminate rules that inhibit product innovation, and to encourage free product development. By the way of example, deregulation in the bond market have already resulted in numerous types of products being launched. Yet there are cases where constraints have emerged in relation to basic laws such as the Commercial Code and the Criminal Code, thereby making difficult the use of some products that are commonly seen in overseas markets.

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2. *Market (An efficient and trusted framework for transactions)*

(1) Introduction

Efficiency and fairness are the two most important elements in a marketplace where transactions take place. It was generally thought that efficiency and fairness can be best achieved by screening the firms that are allowed access to the market to raise funds, and then requiring transactions to take place at a centralized exchange or other similar venues. However, progress in electronics and communications as well as financial technology has opened up the possibility of alternative transaction methods. Also, in order to encourage new business, access to the capital market should be made available to a wider range of firms. It is worth noting that systems can now be constructed that ensure fairness of

transactions without requiring them to take place at exchanges. One should also take into account that, with the globalization of the market, restrictions at home could drive transactions overseas, resulting in a hollowing out of the market, under which circumstance efficiency and fairness may not be achieved.

It is important that different markets compete under a common set of fair transaction rules and other investor protection rules, so that transactions can be more liberally undertaken. This is in accordance with the basic philosophy underlying this reform. More specifically, the following measures should be taken:

(2) Creating diverse and outstanding markets

In order to respond to varied transaction needs of investors:

- For stock exchanges, in addition to efforts to review and improve the transaction system within exchanges, the requirement of consolidation of order-flow for listed securities should be abolished, and off-exchange transactions permitted.
- For the registered OTC (JASDAQ) market, its characterization as one that complements the stock exchange market should be rectified, and measures should be taken to strengthen its function by improving its secondary market capacities.
- For unlisted and unregistered securities, securities companies should be allowed to trade and intermediate these shares actively, after appropriate rules are put into place to ensure fairness of transactions.

In addition, in terms of market infrastructure, measures that include the following should be undertaken:

- Broaden access to transaction and quote information.
- Improve the clearing and settlement system for securities.
- Improve the share lending market.

Together, these steps will widen the choice of markets available to investors and issuers. Through competition among markets, the efficiency and functioning of the securities market system as a whole should improve.

(3) Enhancement of market efficiency and the issue of cross-holdings of shares

Strengthening the competitive environment of the market is aimed not only at improving the quality of services available to the users, but also at improving the efficiency of price formation. Efficient price formation helps to bring together the varied views of investors concerning a firm's future profitability and other aspects, reflecting them in bond and share prices. These prices in turn drive the funding and investment decisions, and results in efficient allocation of resources based on market principles. Moreover, the share price acts as the market's judgment on the ability of the firm's management, and thereby exerts pressure on the management to realize a more efficient use of capital and to improve the competitiveness of the firm.

An important issue in this context is the widespread cross holding of shares that are aimed at consolidating inter-corporate business and securing stability of corporate management. Cross-holdings are often cited as a peculiarity of the Japanese stock market that inhibits the functioning of the market.

On this point, there are views that holdings motivated by non-financial objectives need not be rejected, and that the effect of such decisions on prices should not be seen to be distorting, and that in any event, economically irrational cross-holdings are dissolving on its own accord.

These views notwithstanding, there are those who hold that share holders in mutual holdings situations may not exercise shareholder rights in full and thereby tend to weaken corporate governance, and also that cross-holdings introduce investment decisions that are strategic in nature, and thereby discourages the willingness to invest of investors who focus solely on financial returns, thus hindering the operation of market mechanism.

3. *Financial Intermediaries (Diverse investment services to fulfill client needs)*

(1) Introduction

Innovation in the market is ultimately driven by intermediaries. As the environment becomes more conducive to innovation, the role of intermediaries becomes even more important. In particular, a framework must be built, wherein intermediaries that respond to client needs and develop products and services with high value added will flourish. As securities market reform proceeds, competition between intermediaries, including new entrants, will become the key to providing better services for the users of the market.

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(3) Deregulation of Brokerage Commissions

a. Total deregulation of brokerage commissions

To encourage the supply of differentiated services, an incentive structure is also needed in addition to a legal framework permitting such activity. Together with allowing securities firms freedom in business strategy, brokerage commissions should be liberalized fully. This would allow customers to choose between different combinations of price and services, and would increase the welfare of investors.

b. Implementing deregulation

Freeing of brokerage commissions has profound implications, not only on brokerage firms, but also on investors and other market participants. It therefore needs to be considered within the overall framework of securities market reform. It is also important to note that deregulation of brokerage commissions is linked closely with measures such as abolition of order-flow consolidation rules and the introduction of wrap account services. The effects of the implementation of the revised Foreign Exchange Law in April 1998 in a globalized market also need to be considered.

Bearing these factors in mind, the liberalization of brokerage commissions should be introduced following the schedule indicated below.

c. Deregulation Schedule

First, in April 1998, commissions that apply to transaction value in excess of 50 million Yen should be liberalized. After necessary measures have been put into place to diversify lines of business and to introduce new products, and necessary computer system investment has been undertaken, completely liberalized commissions should be in place by end-1999. Adjustments to the computer system will necessarily require certain time, but since it is in the interest of market users as well as the market, for complete deregulation to take place as soon as feasible efforts by those involved in the market to accelerate the process will be most welcome.

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(5) Entry regulations and supervision of intermediaries

a. General principles

In order to encourage creative and innovative activity, supervision of financial intermediaries should employ as few regulation as possible that limits freedom of business activity. The approval system for business operations procedure should be abolished. To strengthen financial intermediation, it is also necessary for new entrants to bring in new ideas, technology and vitality into the securities market.

b. Reforming entry regulations (from licensing to registration for securities companies)

It would be difficult to maintain dynamism of the securities market, if those that are capable and willing, find it difficult to enter the securities industry. Securities industry is

expected, above all, to be innovative and provide varied and attractive services to clients. Regulations governing entry into securities business should be as liberal as possible.

Even so, securities companies must maintain the trust of their clients, as securities companies' important role is to provide access to the securities market. Obviously, one should not attempt to encourage new entrants into securities business by merely lowering the standards required for entry. Potential entrants must possess a minimum level of financial and human resources required to execute business in an honest and reliable manner. The standards that are required would differ between different types of activity, reflecting the degree of specialized skills and necessary risk management levels.

In considering the most appropriate legal framework for achieving these objectives, one should bear in mind that securities companies will not be required to refrain from non-securities business, and also that measures will be taken to clearly segregate customers' asset from the securities companies own assets in the course of this reform. Therefore, the Council believes that, provided a mechanism for securities companies meeting and maintaining certain minimum standards can be constructed, the current licensing regime should be replaced in favor of a registration scheme. Within this registration scheme, specific lines of business that require special skills and a higher degree of risk control, such as OTC derivatives business and underwriting business, may require explicit approval from the regulator, so that the required standards may be met.

In asset management area, there is the need to ensure investor protection while encouraging competition. Bearing in mind the reform of the entry regulation regime for securities companies and also taking into account the special characteristics of asset management business, investment trust management and discretionary investment management in investment advisory business should be subject to regulatory approval upon entry.

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V. CONCLUDING REMARKS

When the above reform package is completed, the Japanese market should become comparable in its market infrastructure to US and European markets. However, reforming the market system and supervisory framework will not, by itself, achieve the ultimate objective of reinvigorating the securities market and thereby helping Japan maintain the vigor of its economy. That will ultimately depend on factors that lie beyond the securities market.

One is the basic legal system such as that embodied in Civil and Commercial Codes. The issue here is whether it can be made to comply with international financial market practices while still conforming to Japan's traditional values and the realities of the Japanese society. Germany and France, which have similar legal structure as Japan's, have recently introduced a number of legal reforms aimed at invigorating capital market. Japan should follow their lead in revamping some of these basic laws. For clear and transparent rule to be applied speedily and consistently, judicial underpinning is also important.

Another factor is the issue of the tax system, in relation to increasing efficiency and international competitiveness of the market. It is hoped that an urgent review of the tax system will be undertaken in the Tax Research Council and other venues, and that the review will taken into account the views of this Council expressed in this report.

However, it must be said that the most fundamental factor in reviving the market is the ability of Japan's intermediaries, firms and investors to use this new found freedom. Whether a free and efficient market framework will indeed lead to a revitalized market in its true sense, rests squarely on the actions of market participants. Intermediaries must show creativity and dynamism and lead the market in the new environment. Freedom requires discipline and responsibility. Market participants should all make maximum use of the freedom given them, and act with integrity and discipline backed by a high ethical standard.

The Securities and Exchange Council believes in the ability and the awareness of the Japanese people. The Council urges the Government to proceed to refine the details of this reform package, and provide the required institutional framework without delay, taking into account as wide a range of public opinions as possible. By laying the ground for the development of Japan's securities market, it is hoped that the securities market will contribute towards providing a basis for the creation of a fair and dynamic economy and society.

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