Fordham International Law Journal

Volume 18, *Issue* 5 1994 *Article* 26

Japanese and U.S. Financial Derivatives Markets: Recommendations for Loosening Japan's Tightly Regulated Market

Marc Levy*

*Fordham University

JAPANESE AND U.S. FINANCIAL DERIVATIVES MARKETS: RECOMMENDATIONS FOR LOOSENING JAPAN'S TIGHTLY REGULATED MARKET

*Marc Levy**

INTRODUCTION

Substantial losses suffered by powerful financial institutions in recent months due to derivative instruments[1] have triggered calls for increased regulation of financial derivatives markets.[2] Because derivatives potentially can devastate institutions that improperly employ them, Japan, a country with little experience in the derivatives markets,[3] seeks to insulate its financial markets

* J.D. Candidate, 1996, Fordham University.

1. *See* KENNETH R. KAPNER & JOHN F. MARSHALL, THE SWAPS HANDBOOK: SWAPS AND RELATED RISK MANAGEMENT INSTRUMENTS 494 (1990). "Derivative instruments" are financial instruments that derive their value from some other instrument or asset, such as futures and options. *Id.* There are many types of derivatives. DAVID L. SCOTT, WALL STREET WORDS 96 (1988). For example, an option is a type of derivative instrument that secures value from the underlying security that may be purchased by exercising the option. *Id.* The "underlying asset" is simply the asset that gives value to the derivative security. *Id.* at 371-72. For instance, the underlying asset of a stock option is the stock that may be purchased if the option is exercised. *Id.*

2. *See* Sara Webb et al., *Britain's Barings PLC Bets on Derivatives—and the Cost is Dear*, WALL ST. J., Feb. 27, 1995, at A1 (discussing collapse of Barings PLC, two-century-old British investment bank, from derivatives transactions executed by one of its traders in Singapore); Steven Lipin & Jeffrey Taylor, *Bankers Trust Settles Charges on Derivatives*, WALL ST. J., Dec. 23, 1994, at C1 (chronicling losses suffered by Gibson Greetings Co. from derivatives contracts suggested for investment by Bankers Trust, leading U.S. derivatives dealer); G. Bruce Knecht, *Derivatives Lead to Huge Loss in Public Fund*, WALL ST. J., Dec. 2, 1994, at A3 (explaining Orange County, California's losses of over US$1.5 billion from aggressive investing techniques of Robert Citron, county's treasurer, in derivative instruments); Jack Reerink, *Inside the MG Trading Debacle*, FUTURES, Apr. 1994, at 58 (noting losses of oil trading firm MG Corp, U.S. subsidiary of German metals and mining conglomerate, which amounted to US$1.3 billion from investments in derivatives on New York Mercantile Exchange). "Derivatives are being singled out partly because they are misunderstood, or not understood at all—often being dismissed summarily as so complex as to defy customary safeguards." *The Beauty in the Beast*, ECONOMIST, May 14, 1994, at 21, 22. Derivatives, however, are simply another financial tool which financiers and managers need to master. *Id.* at 24. Although the instruments are powerful for the inexperienced, this doesn't necessarily suggest more regulations are needed. *Id.* "[T]he same could be said of motor cars, and few people would advance that as an argument for more traffic lights." *Id.*

3. Shuzo Aoki, *Financial Futures Markets in Japan and Their Legal Framework*, *in* CAPITAL MARKETS AND FINANCIAL SERVICES IN JAPAN 223, 223 (1992). The financial futures market began in October 1985, with the introduction of the Japanese Government Bond futures contract on the Tokyo Stock Exchange ("TSE"). *Id.* A futures contract, or future, is a standardized contract executed by two parties that calls for deferred deliv-

against this possibility by tightening regulations.[4] While derivatives have existed in the United States since 1974,[5] Japan's financial regulatory agency, the Ministry of Finance ("MOF"), seeks guidance from U.S. financial markets in order to develop the Japanese derivatives markets.[6] Japan could decide to follow U.S. proposals for regulation of the U.S. markets, which benefit from more experience with derivatives than Japanese regulators, or Japan could favor minimizing regulations of derivatives in order to attract increased investment and to allow its derivatives markets to grow.[7] With heavy regulations already imposing burdensome

---

ery of commodities and financial instruments. KAPNER & MARSHALL, *supra* note 1, at 500. Upon delivery of the commodity or instrument, the contract is settled with the payment of cash. *Id.*

4. *See Japan to Stiffen Derivatives Audits, Disclosure for Banks, Securities Firms*, Int'l. Bus. & Fin. Daily (BNA) (Jan. 27, 1995). The Ministry of Finance ("MOF") has recently increased audit staff and demanded tighter disclosure requirements from financial institutions trading in derivatives. *Id.* The MOF additionally seeks to impose new controls on the futures industry by maintaining the power to ban speculative trading whenever MOF deems it necessary. *Back to the Futures: Japanese Derivatives*, ECONOMIST, Apr. 24, 1993, at 82.

5. Commodity Futures Trading Commission Act, Pub. L. No. 93-463, 88 Stat. 1389 (1974) (codified as amended in scattered sections of 7 U.S.C.). The Commodity Futures Trading Commission Act created the federal regulatory commission, the Commodity Futures Trading Commission ("CFTC"), to supervise all futures activity. *Id.*; Commodity Exchange Act, 7 U.S.C. § 4a.

6. Hideaki Yamashita, *Futures and Options on Security Derivatives*, *in* CAPITAL MARKETS AND FINANCIAL SERVICES IN JAPAN 215, 222 (1992). As a slow-starter in the derivatives markets, Japan "could learn from experiences of early-starters." *Id.*; *see Japan a 'Developing Country' in Derivatives: Think Tank*, Japan Econ. Newswire, Oct. 26, 1994, *available in* LEXIS, News Library, JEN File (noting that although domestic volume has tripled in past two years, Japan accounts for just one-tenth of world trading in financial derivatives, such as bond and stock futures and options contracts).

7. *See* SARKIS J. KHOURY, THE DEREGULATION OF THE WORLD FINANCIAL MARKETS 54 (1990). Deregulation increases financial flexibility of investors, reduces transaction costs, and attracts new capital to financial markets. *Id.* "The deregulation of financial markets should be considered an investment in the financial well-being of a nation." *Id.* For example, banking institutions that operate in a "deregulated environment" decide "between safety and profitability." *Id.* The safety derives from larger capital reserves and investments in " 'safer' assets." *Id.* The banks seek profit through increased investment opportunities, but at the expense of the banks' assuming undue risk. *Id.* Competition for capital has reached a global scale in recent years. Richard C. Breeden, *Reconciling National and International Concerns in the Regulation of Global Capital Markets*, *in* THE INTERNATIONALISATION OF CAPITAL MARKETS AND THE REGULATORY RESPONSE 27 (John Fingleton ed., 1992). Evidence of the globalization of capital markets abounds:

- one out of every seven equity trades worldwide involves a foreign party on one side or the other;
- between 1984 through 1990, Japanese investors increased their holdings of [non-Japanese] securities by 30% per year, German investors increased

costs in the Japanese derivatives markets and driving investment capital to overseas markets,[8] Japan could reduce restrictions and absorb the increased risk.[9]

This Note examines whether Japan should impose more restrictions on its derivatives markets. Part I discusses the developmental history of Japan's financial markets and then examines the current structure of Japan's capital markets and the regulatory bodies responsible for their supervision. Part I also introduces the basic concepts of derivatives and the risks associated with using such instruments. Next, Part II compares the regulatory structures of the derivatives markets in the United States and Japan. Part II also explores the recent U.S. congressional proposals for reform of U.S. derivatives markets, and discusses the effect of heavy regulation of Japanese derivatives markets. Part III suggests that Japan is prone to follow the proposed U.S. solutions to the problem of derivatives-related losses, thereby increasing regulation of the Japanese derivatives markets. Part III, however, cautions Japan against implementing such strict regulation of derivatives markets because of the resulting negative consequence of increased transaction costs, encouraging investors to shift capital to overseas markets and decreasing investment in Japan. This Note concludes, instead, that by deregulation of the derivatives markets, Japan will be in a position to attract capital and, should the United States elect to further regulate the derivatives market, benefit from the increased investment opportunities exiting the U.S. market.

---

theirs by 18% per year, UK investors by over 17% per year, and U.S. investors by 14% per year.

Id. at 27-28.

8. *See* Linda Sieg, *Worries Remain of U.S. Derivatives Legislation*, Reuters, Oct. 26, 1994, *available in* LEXIS, News Library, REUAPB File (explaining that participants in Tokyo financial markets claim that "excessive formal and informal regulations are dampening derivatives deals and forcing potentially lucrative business offshore"). Despite rapid changes in the financial markets since the 1970's, the MOF has refused to remove all barriers in the markets. Thomas F. Cargill & Gregory F.W. Todd, *Japan's Financial System Reform Law: Progress Toward Financial Liberalization?*, 19 BROOK. J. INT'L. L. 47, 81 (1993).

9. *See* Breeden, *supra* note 7, at 29. Financial markets in different countries may require alternative levels of regulations to balance domestic market needs for safe investing against "the realities of international competition." *Id.*

I. *HISTORICAL BACKGROUND OF JAPANESE FINANCIAL MARKETS AND PRESENT STATUS OF JAPANESE DERIVATIVES TRADING*

Prior to World War II, capital markets[10] played a minor role in Japan's financial activities.[11] Following World War II, however, the Allied Occupation[12] ("Occupation") authorities imposed new requirements upon the Japanese financial system[13] that sparked a period of economic transformation until the mid-1970's.[14] After joining the leading industrial nations as a major world economy during the 1970's,[15] Japan succumbed to combined domestic and international forces by amending its financial regulatory structure.[16] The abandonment of a fixed ex-

10. *See* SCOTT, *supra* note 1, at 48. The capital market is defined as "the market for long-term funds where securities such as common stock, preferred stock, and bonds are traded." Id. The term common stock is that "class of capital stock that has no preference to dividends or any distribution of assets." *Id.* at 65. Common stockholders are the owners of a corporation in that they have a claim over remaining assets after liquidation. *Id.* Alternatively, most types of preferred stock show "ownership in a corporation and give[ ] the holder a claim prior to the claim of common stockholders" on the corporation's earnings, in addition to the corporation's assets in the event of a liquidation. *Id.* at 266.

11. ARON VINER, INSIDE JAPANESE FINANCIAL MARKETS 1 (1988).

12. *See* JOHN OWEN HALEY, AUTHORITY WITHOUT POWER: LAW AND THE JAPANESE PARADOX 105 (1991). The Allied Occupation ("Occupation") instituted reforms to demilitarize and democratize Japan, including a new constitution. *Id.* General Douglas MacArthur, the supreme commander for the Allied powers ("SCAP"), supervised the Occupation's policies. T.F.M. ADAMS & IWAO HOSHII, A FINANCIAL HISTORY OF THE NEW JAPAN 20 (1972). "The supreme commander Allied powers was an American and the commander in chief of the armed forces Pacific, which constituted the bulk of the occupation troops. Hence the administration of occupied Japan was largely based on American policies." *Id.*

13. Makoto Yazawa, *A Synopsis of Securities Regulation in Japan*, *in* JAPANESE SECURITIES REGULATION 23, 28 (Louis Loss et al. eds., 1983).

14. TAKEJI YAMASHITA, JAPAN'S SECURITIES MARKETS: A PRACTITIONER'S GUIDE 2 (1989). Transformation of the Japanese economy from its state after World War II into its powerful role in the 1970's indicated a rapid and intense pursuit of Western economies. *Id.* Japan's resurrection of its financial markets was partly attributable to the introduction of "Western technology" and "low-cost energy." *Id.* By 1973, Japan's dependence on oil abruptly ended its high-growth era after Middle Eastern countries raised oil prices. *Id.*; *see* INTERNATIONAL ENERGY AGENCY, WORLD ENERGY OUTLOOK 21 (1982) (explaining how Middle East disrupted oil markets in 1973, leading to worldwide slowdown of economic activity and crises in oil-dependent economies).

15. VINER, *supra* note 11, at 3. After 1968, Japan's gross national product was second to the United States. KAZUO TATEWAKI, BANKING AND FINANCE IN JAPAN 1 (1991). Gross national product, or "GNP," is the output in dollar terms of finished goods and services in the economy during one year. SCOTT, *supra* note 1, at 160. It is a standard measure of the economic vitality of a country. *Id.*

16. VINER, *supra* note 11, at 3. The banking and securities industries, which re-

change rate system[17] after 1973, and pressure by the United States for reform during the 1980's,[18] triggered expansion of Japan's capital markets.[19] Today, the MOF manages a tightly regulated economy[20] primarily by overseeing securities regulation[21]

---

mained compartmentalized throughout the post-World War II period, expanded and merged their operations so as to accommodate foreign banks and securities companies that were demanding equal access to sources of funds in Tokyo. *Id.*

17. Cargill & Todd, *supra* note 8, at 56-57. A foreign-exchange rate is "the number of units of one currency that can be purchased for one unit of another currency." KAPNER & MARSHALL, *supra* note 1, at 6. A fixed exchange rate entails active intervention by the government to sustain the currency at a particular level. *Id.* In contrast, a floating rate is subject to market forces of demand for the currency and existing supply. *Id.* The Bretton Woods Agreement, Act of July 31, 1945, ch. 339, § 14, 59 Stat. 512 (codified as amended in scattered sections of 22 U.S.C.) [hereinafter Bretton Woods Agreement Act], served as the model for international exchange rate systems following World War II. *See* Bretton Woods Agreement Act, 22 U.S.C. § 286k (1988 & Supp. V. 1993) (indicating U.S. policy toward exchange rate transactions); KAPNER & MARSHALL, *supra* note 1, at 6. The Bretton Woods Agreement was negotiated among 47 Western nations at the end of World War II in the town of Bretton Woods, New Hampshire. KAPNER & MARSHALL, *supra* note 1, at 6. The Bretton Woods Agreement Act authorized the United States to join the International Monetary Fund and the International Bank for Reconstruction and Development. Bretton Woods Agreement Act, 22 U.S.C. § 286 (1988 & Supp. V. 1993). The Bretton Woods system established a fixed exchange rate system based on the dollar and gold. KAPNER & MARSHALL, *supra* note 1, at 6. Although the agreement imposed monetary discipline on each participant, it broke down in the early 1970's. *Id.* It disassembled as a result of "excessive monetary expansion on the part of the United States." *Id.* Most exchange rates involving the dollar have been allowed to float ever since. *Id.* Thereafter, exchange rates became extremely volatile without the standard of the dollar, in turn creating an "ideal environment" for countries to participate in foreign exchange speculation. *Id.*

18. Cargill & Todd, *supra* note 8, at 56-57. The trade deficit with Japan forced the United States to seek to "internationalize" the yen, to encourage Japan to allow non-Japanese access to financial markets, and to increase generally the pace of Japanese domestic liberalizations. *Id.* at 56 n.31. A "trade deficit" exists where there is an "excess of goods and services that a country buys from abroad over goods and services sold to other countries." SCOTT, *supra* note 1, at 363.

19. Cargill & Todd, *supra* note 8, at 56-57. Expansion of the Japanese financial markets was illustrated by deregulation of loan rates; increased reliance by corporations on capital markets; interest rates becoming market-determined in money and capital markets; valuation of the yen based on market forces; and the increasing use of the yen as a desirable reserve by foreign banks. *Id.* at 57.

20. *See* VINER, *supra* note 11, at viii ("Japan is, and will continue to be for quite some time, the most tightly regulated and compartmentalized economy in the free world."). The MOF has sought to control the process of liberalization in the financial markets. Cargill & Todd, *supra* note 8, at 81. "Japanese regulators . . . become anxious at the thought of unleashing the resources of the private sector in an unfettered free market." *Id.*

21. Curtis J. Milhaupt, *Managing the Market: The Ministry of Finance and Securities Regulation in Japan*, 30 STAN. J. INT'L L. 423, 444 (1994). The author describes three elements of securities regulation in Japan that contrast with the U.S. model on which it was based: "the institutional structure and jurisdiction of [MOF], the ministry's licens-

and supervising the banking and insurance industries.[22] Despite this era of rapid expansion, however, the introduction of trading in complex derivative arrangements in 1985 did not result in a formally regulated structure until 1988,[23] and remains in its developing stage.[24]

A. *Japan's Financial Markets: Historical Perspective and Present Structure of the Financial Market System*

The present structure of Japan's financial system represents three decades of rapid expansion from the years immediately following the end of World War II in 1945.[25] Today, the MOF acts as the primary regulatory authority over the Japanese econ-

---

ing authority over securities companies, and the lack of private monitoring of the securities markets." *Id.*

22. *Id.* at 446.

23. *See* Financial Futures and Exchange Law, Law No. 77 of 1988, art. 1 (Japan) (revised in 1992) (Survey Japan trans., 1992) [hereinafter FEL]. The Japanese government created the Financial Futures Exchange with the enactment of the FEL in 1988. *Id.* Thereafter, only members of the Financial Futures Exchange could execute transactions in financial futures. *Id.* art. 35. The FEL defines "financial futures transactions" as "dealings made at the financial futures market pursuant to the standard and means prescribed by the Financial Futures Exchange," and lists the types of transactions as

> (1) Dealing agreed to by the parties concerned for the purpose of giving and receiving currency money, etc., as well as their epuivalent [sic] at a certain time in the future, which can be settled by giving and taking the differences in prices in the case of currency money, etc., as an object [until] the relevant transaction[s] are resold or repurchased.
>
> (2) Dealing agreed to by the parties concerned with the purpose of giving and receiving money the value of which is based upon the differences between the numerical value agreed to in advance by the parties as the financial indicator (hereinafter called "agreed numberical value") and the actual numerical value of the relevant financial indicator for a certain period in the future.
>
> (3) Dealing agreed by one of the parties concerned to grant the other party a right which enables the party to settle the following dealings between the parties by a declaration of the intention of one of them (hereinafter called "financial option") and to pay the other party the value equivalent to this . . . .

Id. art. 2.4. Article 2 of the Securities and Exchange Law of 1948 permits parties to enter derivatives transactions based on securities. *See* Securities and Exchange Law, Law No. 25 of 1948, art 2.14 (Japan) (as amended to 1992) (Capital Markets Research Inst. ed. & Toru Mori trans., 1993) [hereinafter SEL] (permitting parties to enter transaction based on value of securities index).

24. *See Japan a 'Developing Country' in Derivatives: Think Tank*, *supra* note 6 (noting that although domestic volume has tripled in past two years, Japan accounts for just one-tenth of world trading in financial derivatives).

25. *See* ADAMS & HOSHII, *supra* note 12, at 21 (describing Occupation's reforms as affecting every phase of life in Japan for period of several years). Immediately following World War II, Japan restructured its economy based on guidance from the Occupation authorities. *Id.* By the 1970's, Japan had become the second most powerful financial

omy.[26] Japan's present financial system resembles the structure of other industrialized nations.[27] Generally, such a structure contains a commercial banking system,[28] government-owned financial institutions,[29] securities companies,[30] capital markets,[31] and money markets.[32]

1. Evolutionary Period of the Japanese Financial Markets From the Pre-World War II Period Until Today

The *zaibatsu* holding companies[33] were integral to Japan's early economic and financial development.[34] The post-World War II period marked a turning point for the Japanese financial markets, mainly resulting from the influence of the Occupation.[35] After a period of rapid economic expansion from 1955 to 1961,[36] Japan joined the global marketplace as a major economy.[37]

---

country in the world. *See* TATEWAKI, *supra* note 15, at 19-20 (explaining Japan's second-rated status in gross national product).

26. *See supra* notes 20-22 and accompanying text (discussing MOF as supervisor of Japanese economy, including securities, banking, and insurance industries).

27. VINER, *supra* note 11, at 3.

28. *Id.* The commercial banking system accepts deposits from individuals and institutions, lends funds to businesses, and executes foreign exchange transactions. *Id.*

29. *Id.* at 4. The government owns specialized financial institutions that help fund specific sectors of the economy, such as the Export-Import Bank of Japan, the Small Business Finance Corporation and the Housing Loan Corporation. *Id.* at 4-5.

30. *Id.* at 4. The securities companies provide brokerage services, underwriting syndicates for corporations, and deal in the securities markets. *Id.*

31. *Id.* The capital markets offer a means for public and private sector financing. *Id.*

32. *Id.* The money markets provide banks with borrowed funds and enable the central bank to implement monetary policy. *Id.*

33. *Id.* at 1. The *zaibatsu* consisted of "family-owned bank-centered holding companies," and symbolized the "world's first multinational conglomerates." *Id.*

34. *See id.* ("[T]he financial market history of prewar modern Japan . . . is largely the story of the flow of funds and goods among Japanese government institutions on the one hand and *zaibatsu* controlled entities on the other.").

35. *See* TATEWAKI, *supra* note 15, at 9-10 (discussing major reforms of Occupation, including closing all wartime financial institutions and revision of securities regulation with SEL of 1948).

36. JAPAN SECURITIES RESEARCH INSTITUTE, SECURITIES MARKET IN JAPAN 1992, at 16-17 (1992). The stock market experienced two booms that resulted in rapid increases in stock prices. *Id.* at 16. The stock price average of the TSE quadrupled from its 1955 average of 374 points to its 1961 average of 1549 points. *Id.* at 17.

37. *See supra* note 25 (discussing Japan's ascendancy to world's second largest economy, behind United States, by 1970's).

a. Pre-World War II Period

During the pre-World War II period of dominance by the *zaibatsu*,[38] securities regulation centered around spot[39] and arbitrage transactions.[40] The Stock Transaction Ordinance of 1874[41] signified the earliest attempt to legislate stock trading on an exchange.[42] Because there was no stock exchange,[43] however, this ordinance was later replaced by the Stock Exchange Ordinance of 1878[44] to govern early speculation in grain transactions.[45] Reform of securities regulation took precedence during the ensuing period, culminating in the Exchange Law of 1893 ("1893 Law").[46] The 1893 Law, which would remain in force through World War II, was applied to both securities[47] and commodities[48] exchanges.[49] The 1893 Law authorized organization of the

38. *See supra* note 33 (defining *zaibatsu*). These conglomerates possessed vast economic power, and exerted extensive control over the national economy. Milhaupt, *supra* note 21, at 434.

39. *See* SCOTT, *supra* note 1, at 332 (defining "spot commodity" as one available for immediate delivery). A spot transaction, unlike a time transaction, involves immediate delivery of the particular object of the contract (either a commodity or financial instrument). *Id.*

40. Yazawa, *supra* note 13, at 26. "Arbitrage" is defined as the "simultaneous purchase and sale of substantially identical assets in order to profit from a price difference between the two assets." SCOTT, *supra* note 1, at 15. According to a theory known as the Law of One Price, two assets with identical attributes should sell for the same price, as should one asset trading in two different markets. PETER L. BERNSTEIN, CAPITAL IDEAS: THE IMPROBABLE ORIGINS OF MODERN WALL STREET 171 (1992). If the prices of identical assets should differ, one can make a profit by selling the asset that is overpriced and buying it back where it is underpriced. *Id.* The arbitrager, who specializes in detecting such misallocations in the markets, locks in a small profit, "otherwise known as a free lunch." *Id.*

41. Kabushiki Torihiki Jorei [Stock Transaction Ordinance] of 1874 (Japan).

42. Yazawa, *supra* note 13, at 26.

43. *See id.* at 106. The regulations in 1874 were designed to facilitate growth of private corporations. *Id.* The regulations "proved unsuitable for the traditional arbitrage transactions," and combined with the low volume of securities trading, "no one volunteered to establish a stock exchange." *Id.*

44. Kabushiki Torihikisho Jorei [Stock Exchange Ordinance], Great Council of State Proclamation No. 8 of 1878 (Japan).

45. Yazawa, *supra* note 13, at 26-27.

46. Torihikisho Ho [Exchange Law], Law No. 5 of 1893 (Japan).

47. *See* SCOTT, *supra* note 1, at 316. A "security" is an instrument that defines certain rights and obligations, such as ownership in a corporation (stock) or creditor relationship to a particular firm or government entity (bond). *Id.*

48. *See id.* at 64. A commodity is a "generic, largely unprocessed, good that can be processed and resold." *Id.* In the United States, grains, metals, and minerals are examples of commodities that are traded, generally in very large amounts, in the financial markets. *Id.*

exchanges as either stock corporations[50] or membership organizations.[51] The commodities exchanges became the latter, whereas nearly every stock exchange was organized as a corporation.[52] The 1893 Law also recognized time transactions, or futures trading,[53] in addition to spot transactions,[54] which added a strong speculative flavor to the early trading.[55]

b. Post-World War II Period

The Occupation dissolved the existing organization of the Japan Securities Exchange[56] ("Exchange"), and initially suspended all trading on the Exchange on August 9, 1945.[57] Unable to obtain the Occupation's authorization to reopen, the Exchange dissolved in 1947.[58] Thereafter, the Occupation instituted three changes to the structure and operation of Japan's

---

49. Yazawa, *supra* note 13, at 27.

50. *Id.* at 27. A stock corporation, or "stock company," is a "company owned by stockholders, with the ownership evidenced by transferable certificates." SCOTT, *supra* note 1, at 337.

51. Yazawa, *supra* note 13, at 27. A membership organization is a firm that gains all rights and privileges associated with membership on the exchange. JOHN DOWNES & JORDAN ELLIOT GOODMAN, DICTIONARY OF FINANCE AND INVESTMENT TERMS 251 (1985). A "member firm" may vote on exchange policy, and is also committed to such obligations as settling disputes with customers through exchange arbitration procedures. *Id.*

52. Yazawa, *supra* note 13, at 27. "Stocks of the stock exchanges themselves were listed and traded on the particular exchanges." *Id.*

53. *See supra* note 3 (defining futures contract).

54. *See supra* note 39 (defining spot transaction).

55. Yazawa, *supra* note 13, at 27.

56. *See* SECURITIES MARKET IN JAPAN, *supra* note 36, at 14-15. After the outbreak of World War II, the Japanese government tightened its control over the stock markets. *Id.* at 14. The Japanese financial policy abandoned its free market qualities in deference to the more important goal of allocating funds for the war effort. *Id.* The securities market suffered because the existing 11 stock exchanges were reorganized into "a single quasi-public corporation," which became the Japan Securities Exchange. *Id.* at 15.

57. Yazawa, *supra* note 13, at 28. Securities companies responded to the suspension of trading on the exchanges by executing trades at their own offices as well as on unofficial markets. SECURITIES MARKET IN JAPAN, *supra* note 36, at 15. In order to reopen the securities markets, the Japanese had to meet requirements established by the Occupation authorities. Yazawa, *supra* note 13, at 28.

58. Yazawa, *supra* note 13, at 28. The Occupation created the Securities Coordination Liquidation Commission ("Securities Commission") in June 1947 to dispose of several existing securities. SECURITIES MARKET IN JAPAN, *supra* note 36, at 15. By the time the Securities Commission was dissolved in July 1951, it had sold over 233 million shares of stock valued at over US$39 million, according to the prevailing exchange rate between yen and dollars. Milhaupt, *supra* note 21, at 434.

financial markets.[59]

First, the Occupation changed the structure of Japanese finance by dissolving the *zaibatsu* holding companies.[60] The Occupation sought to democratize Japan[61] and to make the industrial sector more competitive.[62] During the Securities Democratization Movement,[63] power shifted from the previously powerful *zaibatsu* to individual investors.[64]

Second, during this period both city banks and some regional banks assumed leadership roles.[65] The pre-World War II *zaibatsu* formed into new groupings of *keiretsu*.[66] These new companies utilized a strategy called "interlocked cross-shareholding"[67] as a means to control a group of companies within

---

59. Cargill & Todd, *supra* note 8, at 53-55.

60. *See supra* notes 33-34 and accompanying text (defining *zaibatsu* and noting that these companies were integral part of Japan's early financial development). The Securities Commission reorganized 83 *zaibatsu* holding companies, containing 4500 subsidiaries, into less powerful financial companies. VINER, *supra* note 11, at 2.

61. *See* ADAMS & HOSHII, *supra* note 12, at 23-27. The Occupation accomplished its goal to democratize Japan by dissolving the *zaibatsu* and by instituting agricultural and labor reform. *Id.* at 23. Dissolution of the *zaibatsu* resulted in an increase in the number of individual shareholders participating in stock ownership. *Id.* at 26. Similarly, agricultural and labor reform raised the income level of individual farmers and laborers, completing the most important aspects for economic democratization. *Id.* at 26-27.

62. *See id.* at 23. The Occupation demanded that the Japanese government present a plan to strengthen the industrial sector. *Id.* Accordingly, SCAP demanded an overhaul of industrial and commercial combinations, a program to discourage the fostering of private monopolies, and a plan to increase "equal opportunity to firms and individuals to compete in industry and commerce on a democratic basis." *Id.*

63. SECURITIES MARKET IN JAPAN, *supra* note 36, at 15; *see supra* notes 60-62 and accompanying text (explaining Occupation's efforts to democratize Japan by dissolving *zaibatsu* and strengthening industrial sector).

64. SECURITIES MARKET IN JAPAN, *supra* note 36, at 15.

65. Cargill & Todd, *supra* note 8, at 54. Business enterprises demanded credit for financing and growth, which only the banks could supply. TATEWAKI, *supra* note 15, at 10. Except for the Bank of Japan, Japan's financial institutions are categorized as private, Japanese financial institutions, government financial institutions, and non-Japanese financial institutions. *Id.* at 99. The private depository institutions include the city banks and the regional banks. *Id.*

66. VINER, *supra* note 11, at 2. *Keiretsu* is a general term used to describe clusters of affiliated corporations. Milhaupt, *supra* note 21, at 435 n.50. The term *keiretsu* "derived from the word *kei*, meaning 'faction or group' and *retsu*, meaning 'arranged in order.' " VINER, *supra* note 11, at 11. Because the structure of each affiliate differs, they are sometimes grouped separately among "horizontal" and "vertical" *keiretsu*. Milhaupt, *supra* note 21, at 435 n.50.

67. *See* VINER, *supra* note 11, at 2. In this type of structure, each company possessed limited stakes in other *keiretsu* members, usually amounting to one to three percent of equity. *Id.* Thus, a majority of a corporation's shares was held by a concentra-

the collective organization.[68]

Third, the Occupation altered the regulatory structure, marking a new era within the financial markets.[69] The Securities and Exchange Law ("SEL") of 1947,[70] despite its overhaul by the Occupation in 1948,[71] established an independent Japanese Securities and Exchange Commission[72] ("JSEC") to oversee the securities markets.[73] The government, however, abolished the JSEC in August 1952.[74] The MOF assumed primary regulatory authority over Japan's financial markets, followed by the Bank of Japan[75] and the Ministry of Posts and Telecommunications.[76]

---

tion of other companies within the membership. *Id.*; *see, e.g.*, Milhaupt, *supra* note 21, at 435-40 (discussing emergence of cross-shareholding in three major stages, beginning with reacquiring of shares by large corporate groups from those securities distributed to individuals during securities democratization movement in 1950's and ending with financing of equity capital by banks in 1980's). "Equity" refers to both common and preferred stock. SCOTT, *supra* note 1, at 118. "For example, an investor may prefer investing in equities as opposed to bonds." *Id.*

68. VINER, *supra* note 11, at 2.

69. Cargill & Todd, *supra* note 8, at 53. To provide a legal framework to accompany the democratization movement, SCAP directed the Securities Division of the MOF in preparing the new Securities and Exchange Law of 1947. ADAMS & HOSHII, *supra* note 12, at 51; Securities and Exchange Law, Law No. 22 of 1947 (Japan). Because SCAP engineered the draft of the new law, the law represented powerful U.S. influence. *Id.*

70. Securities and Exchange Law, Law No. 22 of 1947 (Japan). The first version of the Securities and Exchange Law, enacted in 1947, dissolved the Japan Securities Exchange and redirected supervisory power over securities regulation from the MOF to an independent agency, the Japanese Securities and Exchange Commission ("JSEC"). Milhaupt, *supra* note 21, at 430-31. SCAP did not approve of the 1947 statute, however, and, as a condition for reopening the exchanges, the statute was rewritten to fashion a system more closely resembling the U.S. regulatory regime. *Id.*

71. SEL, Law No. 25 of 1948 (Japan). Under SCAP's direction, the revised SEL of 1948 paralleled the U.S. Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1988 & Supp. V 1993) [hereinafter Securities Act], and the U.S. Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78ll (1988 & Supp. V 1993) [hereinafter Exchange Act]. Milhaupt, *supra* note 21, at 431.

72. *See* JONATHAN ISAACS & TAKASHI EJIRI, JAPANESE SECURITIES MARKET 2 (1990). The Japanese Securities and Exchange Commission ("JSEC") was established as an independent administrative body, and was modelled on the U.S. Securities and Exchange Commission. *Id.*

73. Milhaupt, *supra* note 21, at 433.

74. *Id.* During the latter half of 1951, as the Occupation was ending, a Japanese governmental panel recommended abolishing the JSEC because it was perceived to be ineffective. *Id.* The MOF opposed the JSEC's creation because the new agency assumed securities-related powers previously retained by the MOF. *Id.* at 432. The JSEC was abolished in 1952 when the MOF assumed daily administrative responsibilities over the securities industry. ISAACS & EJIRI, *supra* note 72, at 2.

75. Cargill & Todd, *supra* note 8, at 53. The Bank of Japan directs monetary policy

In exercising control over the Japanese securities markets, the Occupation authorities conditioned the reopening of the stock markets[77] upon three principles.[78] First, every transaction executed on a securities exchange[79] had to be recorded in chronological order.[80] Second, all member firms of the exchanges had to trade listed securities[81] solely on a securities exchange.[82] Third, the Occupation banned futures trading.[83] In order to satisfy the Occupation's requirements for reopening the securities markets, the SEL, amended by the Japanese government in 1948,[84] superseded the Exchange Law of 1893.[85] The SEL of 1948 represented a modified version of the U.S. Se-

---

and maintains orderly credit conditions in the financial system by defending the yen, the Japanese currency. VINER, *supra* note 11, at 326.

76. Cargill & Todd, *supra* note 8, at 53. The Securities Division of MOF's Finance Bureau, which today is called the Securities Bureau of the MOF, was given the sole responsibility of administrative oversight of the securities markets. Milhaupt, *supra* note 21, at 433. The Ministry of Posts and Telecommunications administers the vast Postal Savings System, in which fixed savings are deposited. TATEWAKI, *supra* note 15, at 142.

77. *See supra* note 57 and accompanying text (explaining suspension of trading by Occupation).

78. Yazawa, *supra* note 13, at 29.

79. *Id.* "Securities exchange" is a facility where organized trading of securities takes place. SCOTT, *supra* note 1, at 315.

80. Yazawa, *supra* note 13, at 29.

81. *Id.* A "listed security" is any security traded on an established securities exchange. SCOTT, *supra* note 1, at 201. These are generally more liquid than securities that do not trade on an exchange. *Id.* The term "liquid" refers to "an asset that may be bought or sold in a short period of time with relatively small price changes engendered by the transaction." *Id.* at 199. By contrast, an "illiquid" asset is one that is "difficult to buy or sell in a short period of time without its price being affected." *Id.* at 169. A U.S. Treasury bill is an example of a liquid asset. *Id.* at 199. A large block of stock or a small amount of an infrequently traded stock might be illiquid. *Id.* at 169.

82. Yazawa, *supra* note 13, at 29.

83. *Id.*; SECURITIES MARKET IN JAPAN, *supra* note 36, at 16; *supra* note 3 (defining futures). Because the Occupation abolished futures trading, the practice of time transactions abruptly ended in favor of spot transactions. Yazawa, *supra* note 13, at 29-30.

84. SEL, Law No. 25 of 1948 (Japan); *see supra* note 71 (discussing amendment of SEL to closely parallel U.S. securities laws).

85. Torihikisho Ho [Exchange Law], Law No. 5 of 1893 (Japan); Yazawa, *supra* note 13, at 28. The Occupation was satisfied only initially with a portion of the new Securities and Exchange Law, which established the Securities and Exchange Commission. *Id.* at 29. Certain things were acceptable to the Occupation, such as the licensing system for stock exchanges and the application of the Securities and Exchange Commission as an advisory body for implementing and enforcing the law. *Id.* "This prompted the Occupation authorities to urge the Japanese Government to amend the law in order to incorporate the basic features of the U.S. laws." *Id.*

curities Act of 1933[86] ("Securities Act") and the U.S. Securities Exchange Act of 1934 ("Exchange Act").[87] The SEL of 1948 became central to Japan's system of statutory regulation.[88] The SEL of 1948 altered the oversight of securities regulation, including a new system of securities registration,[89] improved the licensing system for companies engaged in securities business,[90] and segregated securities business from banking business.[91]

c. Post-Occupation Era Until the Present

During the post-Occupation era of 1952 to 1960, Japanese financial institutions increasingly participated in developing the Japanese economy.[92] The Long-Term Credit Bank Law of

---

86. 15 U.S.C. §§ 77a-77bbbb (1988 & Supp. V 1993); *see supra* note 71 (noting similarity of SEL to U.S. Securities Act of 1933).

87. 15 U.S.C. §§ 78a-78ll (1988 & Supp. V 1993); *see supra* note 71 (explaining similarity of SEL to U.S. Securities Exchange Act of 1934); Yazawa, *supra* note 13, at 24. "With the exception of the Philippines and Pakistan, Japan may be the only country to have adopted almost in their entirety the securities regulation statutes of the United States." *Id.* (footnote omitted). Generally, Japanese securities regulation derives its authority from the SEL of 1948, Law No. 25 of 1948 (Japan), the Securities Investment Trust Law, Law No. 198 of 1951 (Japan), *translated in* JAPAN SECURITIES RESEARCH INSTITUTE, JAPANESE SECURITIES LAWS 101 (1982), and the Law on Foreign Securities Firms, Law No. 5 of 1971 (Japan) (as amended to 1981), *translated in* JAPAN SECURITIES RESEARCH INSTITUTE, JAPANESE SECURITIES LAWS 155 (1982). Yazawa, *supra* note 13, at 23-24. The laws are administered by the Bureau of Securities in the Ministry of Finance, the Japanese counterpart of the Securities and Exchange Commission ("SEC") in the United States. *See* 15 U.S.C. § 78d (establishing SEC as commission to oversee U.S. securities laws).

88. Yazawa, *supra* note 13, at 24.

89. *See id.* art. 4 (mandating all securities sold through public offering must first be registered with MOF, except where aggregate amount of selling price is below specified level).

90. *See id.* art. 28 (providing that every company wishing to engage in securities business must first be licensed by MOF).

91. *Id.* art. 65. The SEL forbids banks from engaging in the securities business except where certain conditions are met, such as trading related to government securities. *Id.* art. 65.2(2)(a). The changes in the Japanese system of securities regulation, embodied in the SEL of 1948, included the segregation of securities business from banking business based on the model of the U.S. Banking Act of 1933 (the Glass-Steagall Act). Banking Act of 1933, Pub. L. No. 73-66, §§ 16, 20, 21, 48 Stat. 162, 184-85, 188-89 (codified as amended in scattered sections of 12 U.S.C.); Yazawa, *supra* note 13, at 29.

92. VINER, *supra* note 11, at 2. Financial institutions were oriented exclusively toward domestic recovery, and "[f]avored industries [like power and chemical companies] were nurtured and protected." *Id.* at 3. In addition, Japanese international finance languished in its formative stage, consisting mainly of foreign exchange dealings conducted by the Bank of Tokyo on behalf of the government "and those corporations involved in the exportation of manufactured products." *Id.* Japan's currency, the yen,

1952,[93] authorizing the credit banks to provide long-term capital to corporations, granted banks a central role in the Japanese economy.[94] Aided by government encouragement, interest rate controls, and a variety of legal limitations on the development of bond markets,[95] bank finance became more important than securities-based finance.[96] The Japanese economy entered a period of rapid expansion from 1955 to 1961, and the bond market resumed trading on the Tokyo and Osaka exchanges in April 1956.[97]

The oil crisis of 1973-1974,[98] combined with the vast increase in government debt financing that followed,[99] caused an

---

was not used as a reserve currency by the world's major central banks: 97% of imports and 60% of exports were denominated in non-Japanese currencies. *Id.* "Japan under reconstruction was a provincial nation." *Id.*

93. Long-Term Credit Bank Law, Law No. 187 of 1952 (Japan), *translated in* 6 Law Bull. Series (EHS), BD 1 (1985).

94. *See id.* art. 6, at BD 2-4 (authorizing long-term banks to make loans, to accept deposits, to perform exchange transactions, and to buy and sell securities for limited purposes); VINER, *supra* note 11, at 2.

95. Milhaupt, *supra* note 21, at 440. The dependence on bank finance was accompanied by lagging activity within the capital markets. *Id.* at 440 n.79. The "bond market" is the place where commercial banks and bond houses trade bonds. CHARLES J. WOELFEL, ENCYCLOPEDIA OF BANKING & FINANCE 145 (1994). A bond market comprises mostly institutional investors in state and local government issues. *Id.* A "bond" is an interest-bearing certificate of debt constituting an obligation, by a business corporation or a government, to pay "a principal amount on a stated future date and a series of interest payments . . . until the stated future date." *Id.* at 141.

96. *See* Milhaupt, *supra* note 21, at 440. Japanese investors and economic participants gained financing from the banks rather than the capital markets. *Id.* The exception was for underwriting business, which banks had dominated before the war. TATEWAKI, *supra* note 15, at 10. After the revision of the SEL in 1948, banks were prohibited from underwriting securities other than public bonds, and securities firms took on an increasing role in the markets. *Id.*; *see supra* note 71 and accompanying text (discussing revision of SEL in 1948).

97. SECURITIES MARKET IN JAPAN, *supra* note 36, at 16-17; *see supra* note 36 (describing expansion of Japanese economy in terms of quadrupling of TSE price index between 1955 and 1961).

98. *See* WORLD ENERGY OUTLOOK, *supra* note 12, at 21. In 1973, events in the Middle East disrupted market forces for oil prices. *Id.* Oil prices sharply escalated, and imposed financial hardship on most industrialized countries. *Id.* Countries dependent upon the Middle East for oil had to decrease their purchases of oil, which slowed international economic activity and depressed real income. *Id.* As a result, the shortage of oil caused an economic crisis in oil-dependent economies. *Id.*

99. Cargill & Todd, *supra* note 8, at 55-56. The shortage of oil caused deficits to double in the central government and overall public sectors, which the MOF was unable to fund. *Id.* Thus, the MOF relied even more heavily on banks to fund the purchasing of government debt. *Id.* at 56. Debt, or "liability," is an obligation to pay to another party some amount in money, goods, or services. SCOTT, *supra* note 1, at 196.

initial downward shift in Japan's financial development.[100] Subsequently, Japanese banks began to demand liberalization of the financial system in return for their efforts to bail out the government's debt.[101] The securities markets sought liberalization because of the increasing internationalization of Japanese finance,[102] which offered the securities markets new opportunities to expand their role in the financial system.[103] The corporate sector, which experienced a slower rate of investment, became less dependent on the banking system for financing of its operations.[104] Corporations increased their liquidity and viewed liberalization of the financial system as an opportunity to increase profits and to diversify into financial asset management.[105] The

---

A "deficit" is "[a] negative retained earnings balance," wherein accumulated losses exceed revenue generated to cover those losses. *Id.* at 92.

100. Cargill & Todd, *supra* note 8, at 55-56. The MOF lacked capital with which to fund the government and public sector deficits, which resulted in fewer funds available for economic growth. *Id.*

101. *See id.* at 55-56. Thus, the Japanese banks supported the government by issuing bonds to the public, which it would guarantee in the event of default. *Id.* A "bond" is a written obligation by one party who becomes responsible for the actions of another. SCOTT, *supra* note 1, at 33. The term "default" denotes an inability of a borrower to pay interest or principal on a debt when payment is due. *Id.* The "principal" is simply the face amount of a bond, to which the lender is guaranteed in full upon maturity. *Id.* at 271. The "maturity" date is when "the issuer must retire the bond by paying face value of the bond to its owners." *Id.* at 214.

102. TATEWAKI, *supra* note 15, at 19-21. Japan's status as second in the world in GNP after 1968 caused it to account for a major share of the world's foreign trade and financial transactions. *Id.* at 19-20. Thus, if Japan had not lowered the barriers to Japanese markets, development of international transactions would have suffered during the 1970's. *Id.* at 20. There followed a substantial increase in foreign lending and the number of non-Japanese banks that entered Japan. *Id.*

103. Cargill & Todd, *supra* note 8, at 56.

104. *Id.* The share of financing of corporate businesses declined from 53% in total funding during the period 1970-1974 to 34% in 1980-1984. TATEWAKI, *supra* note 15, at 21. In turn, bank lending declined from 60% in 1970-1974 to 45% in 1980-1984. *Id.* Corporations relied to a smaller extent upon the banks because manufacturing firms no longer felt banks would retaliate by destroying credit relationships. *Id.* Before the oil crisis in 1973-1974, the corporate sector invested in plants and equipment, causing the largest deficit of funds. *Id.* at 24. After the crisis, investment demand for plants and equipment fell, which reduced deficits of the corporate sector. *Id.* By 1978, the corporate sector's deficit "was almost nil." *Id.*

105. Cargill & Todd, *supra* note 8, at 56; *see* TATEWAKI, *supra* note 15, at 24-27 (discussing surplus of cash in corporate sector since early 1970's and investment in plants, equipment, and financial instruments to boost profits). "Financial assets" are financial instruments that possess the benefit of a future claim to cash. WOELFEL, *supra* note 95, at 444. The issuer of the financial asset promises to make future cash payments to the investor, who holds the instrument representing the intangible asset. *Id.* "Asset management" refers to the planning procedure of a financial institution that accounts

household sector[106] sought higher rates of return on their investments after experiencing a period of higher real income growth.[107] Two catalysts, abandonment of a fixed exchange rate system after 1973,[108] and pressure by the United States for reform in the early 1980's,[109] resulted in the expansion of Japan's capital markets.[110]

Division of the Japanese banking and securities sectors by the SEL changed during the 1980's.[111] Article 65 of the SEL[112] excluded banks from engaging in securities operations, including dealing,[113] underwriting,[114] and brokerage of securities.[115]

---

for the institution's assets, including financial assets. *Id.* at 51. "Its intent is to quantify and control risk." *Id.*

106. Cargill & Todd, *supra* note 8, at 56. The household sector is part of the private, non-financial sector. TATEWAKI, *supra* note 15, at 19. In comparison, the personal sector includes households and non-corporate businesses. *Id.*

107. Cargill & Todd, *supra* note 8, at 56. Raises in wages occurred at rates exceeding 10% between the 1950's and 1970's, which spurred demand for higher yielding assets. TATEWAKI, *supra* note 15, at 19. Until 1975, accumulation of financial assets by the private, non-financial sector rose at a rate exceeding the growth rate of nominal GNP. *Id.* The term "nominal return" signifies any rate of return without adjustment for inflation. SCOTT, *supra* note 1, at 234. In contrast, "real income" is defined as income adjusted for inflation, or changes in the prices of goods and services. *Id.* at 286. "Real income measures purchasing power in the current year after an adjustment for changes in prices since a selected base year. If money income increases more than consumer prices, real income increases." *Id.*

108. Cargill & Todd, *supra* note 8, at 56-57; *see supra* note 17 (explaining Bretton Woods exchange rate system, its dissolution in 1973, and its replacement with floating exchange rate system).

109. Cargill & Todd, *supra* note 8, at 56-57; *see supra* notes 16, 18 and accompanying text (explaining U.S. encouragement to internationalize Japanese currency and to allow greater access of non-Japanese banks to Japanese financial markets).

110. Cargill & Todd, *supra* note 8, at 56-57; *see supra* note 19 (noting deregulation of loan rates, corporations' increased dependence on capital markets, relaxation of control over interest rates, and greater acceptance of yen currency in non-Japanese markets as indicators of expanding financial market).

111. Yamashita, *supra* note 14, at 260; *see supra* note 91 (explaining influence of U.S. Glass-Steagall Act on Japan's decision to separate banking and securities industries).

112. SEL, Law No. 25 of 1948, art. 65 (Japan).

113. *See* SCOTT, *supra* note 1, at 87. A "dealer" is "[a]n individual or a firm that buys assets for and sells assets from its own portfolio as opposed to bringing buyers and sellers together." *Id.*

114. *See* SEL, Law No. 25 of 1948, art. 2.6 (Japan). An underwriter acquires all or part of the securities from an issuer for the purpose of selling the amount to the public. *Id.* The SEL additionally includes within the definition of underwriter individuals who contract with an issuer to obtain a remainder of the issue when no one else wishes to acquire it. *Id.* The term underwriter also embraces individuals who "participate[ ] directly or indirectly in the issuance or the sale of the security by public offering." *Id.* An "issuer" signifies "any person who issues or proposes to issue any security." *Id.* art. 2.5.

In addition, the combination of Article 43 of the SEL[116] and Article 10 of the Banking Law,[117] along with Article 65 of the SEL,[118] created the division between securities and banking similar to that created by the U.S. Glass-Steagall Act.[119] Originally, Article 65 was intended to prevent Japanese banks from dominating the financial system and to encourage the development of the secur-

---

115. SEL, Law No. 25 of 1948, art. 65 (Japan). Article 65 defines securities business in reference to Article 2. *See id.* art. 2.8 (listing actions, such as trading in securities futures on security indexes, and options on securities, which constitute securities business excluded to banks). The statute exempts banks from this provision where "securities index futures trading, securities options trading or foreign market's securities futures trading" is undertaken pursuant to a customer order or for investment purposes. *Id.* art. 65. The statute defines "trading in futures of securities index, etc." as

> a transaction under which a party thereto promises the other party to pay an amount of money computed on the basis of the difference between the numerical value agreed to in advance between the parties as an index of the securities concerned . . . or the numerical value agreed to as the price of securities . . . which shall prevail on a certain future date.

Id. art. 2.14 (Japan). All futures trading in securities or securities indexes are restricted to those designated as such instruments by the MOF, or the securities exchange that controls the particular security index. *Id.* The term "securities options trading" is defined as

> a transaction under which a party thereto . . . grants the other party the right to effect any of the transactions below specified between the parties thereto . . . and under which the other party agrees to pay a price for such transaction.
>
> (1) Buying and selling of securities, or
>
> (2) trading in futures of securities index, etc . . . .

Id. art. 2.15.

116. *Id.* art. 43. Article 43 restricts securities firms from engaging in business not defined as securities business under the statute. *Id.*; *see supra* note 115 (discussing Article 2 definition of "securities business"). As an exception, the MOF may specifically designate that a security company's business is "not inconsistent with the public interest or the protection of investors." *Id.* art. 43.

117. Banking Law, Law No. 59 of 1981 (Japan), *translated in* 6 Law Bull. Series (EHS), BA1, 5-6 (1987). This section restricts banks from engaging in any businesses other than banking and businesses auxiliary to banking. *See id.* art. 10.2, at BA 5 (listing services that banks may perform); *see also* Cargill & Todd, *supra* note 8, at 57-58 (noting same).

118. SEL, Law No. 25 of 1948, art. 65 (Japan).

119. Banking Act of 1933, Pub. L. No. 73-66, §§ 16, 20, 21, 48 Stat. 162 (codified as amended in scattered sections of 12 U.S.C. and collectively referred to as Glass-Steagall Act). Japanese banks may hold equity of other companies, but such holdings by banks can not exceed five percent of the equity of another company. *See* Law Relating to Prohibition of Private Monopoly and Methods of Preserving Fair Trade, Law No. 54 of 1947 art. 11, (Japan) *translated in* 2 Law Bull. Series (EHS), KA1, KA16 (1992) (forbidding any company engaged in financial business from owning stock of another company in excess of five percent, or 10% if it is insurance company); YAMASHITA, *supra* note 14, at 260 (noting same); *see also* VINER, *supra* note 11, at 27-28 (noting how Article 65 of SEL of 1948 mirrored Glass-Steagall Act of 1933 in United States).

ities markets.[120] Following the slowdown of economic growth in Japan during the 1970's and the early 1980's,[121] the Japanese government revised both the Banking Law and SEL to clarify the permitted activities of both industries.[122] The separation of operations of banks and securities firms became less apparent due to the actions of Japanese institutions in foreign countries and the activities of non-Japanese institutions in Japan.[123]

---

120. Cargill & Todd, *supra* note 8, at 59. The purposes for Article 65 derived from the Occupation's mandates:

> Whatever the original policy purposes, however, they were purposes of the Occupation, not the Japanese legislature, and in this sense Article 65 fulfills no domestic policy purpose at all. By its endurance . . . Article 65 has become an accepted feature of the Japanese financial system, and . . . it has come to serve a quite different policy purpose than that originally intended.

Id. Article 65 was intended to dilute the financial power held by the banks. VINER, *supra* note 11, at 28. Today, many securities firms have relationships with banks. *Id.* Nomura, established in 1925, was spun off from the bond department of Daiwa Bank (then named Osaka Nomura Bank); Yamaichi Securities Co., established in 1896, has a loose relationship with Fuji Bank and Industrial Bank of Japan; Daiwa Securities Co., traced to Fujimoto Bill Broker (established 1902), confers with Sumitomo Bank; and Nikko Securities Co. works with Mitsubishi Bank. *Id.* The protective territories of Article 65 facilitated such complementary relationships. *Id.* "Had this proviso not existed, there can be little doubt that the powerful city banks, with their extensive networks of branches . . . and corporate relationships, would long ago have absorbed or destroyed the majority of securities firms." *Id.*

121. TATEWAKI, *supra* note 15, at 16-17. The "Nixon oil shock" in 1971, a breakdown of the fixed exchange rate system, and the oil crisis of 1973 triggered major changes in the Japanese economic structure. *Id.* at 16. The Nixon shock signified the impact made on the world economy by President Nixon's statement on August 15, 1971. *Id.* at 1 n.*. Nixon announced policy changes in the conversion of dollars to gold and a proposal for restructuring countries' exchange rates. *Id.* The Japanese economy could no longer support rapid economic growth, and new regulations were adopted to reflect this shift toward slower growth. *Id.* at 16-17.

122. Yazawa, *supra* note 13, at 41-42. The amendments of the Banking Law were the first substantial revisions since 1927. *Id.* Along with the partial revision to the SEL, banks were allowed to engage in securities activities related to government and other public bonds. *See* Banking Law, Law No. 59 of 1981 (Japan), arts. 10.2(2), 10.2(4), *translated in* 6 Law Bull. Series (EHS), BA1, BA5 (allowing banks to buy and sell specified securities); *see also supra* note 91 (noting provision in SEL permitting banks to deal in government-related securities).

123. YAMASHITA, *supra* note 14, at 260. Yamashita notes that U.S. banks have engaged in many activities in Japan, and Japanese subsidiaries of city banks have undertaken many activities in the international markets. *Id.* at 260-61. The Japanese financial system no longer distinguishes between banking and brokerage activities to the extent imposed by Article 65. JONATHAN ISAACS, JAPANESE EQUITIES MARKETS 3 (1990). At present, Article 65 would appear to exist in name alone . . . ." *Id.* A "subsidiary" is a "company controlled or owned by another company." SCOTT, *supra* note 1, at 342. The integration of banks and securities operations in Japan mirrored the same developments in the United States. VINER, *supra* note 11, at 28-29. "As U.S. banks began to provide products and services previously the exclusive domain of brokers and as U.S.

In the late 1980's, the MOF directed two of its advisory councils[124] to examine potential structural reforms of the Japanese financial system, including Article 65.[125] The councils advocated changes that were adopted in the Financial Systems Reform Law of 1992 ("FSRL").[126] The FSRL permitted banks and securities firms to own majority-owned subsidiaries in other fields.[127] The FSRL also empowered the banks to deal in securities, even without establishing a securities subsidiary.[128] The MOF, required to approve separately the "security" status of new products,[129] permitted banks to continue to deal in products not

---

brokers began to provide cash management services bearing a remarkable resemblance to savings accounts, the 'Chinese wall' separating banking and broking activities promised slow dissolution. Japan followed suit." *Id.* at 29; *see* Steven Lipin & Timothy L. O'Brien, *Repeal of Glass-Steagall May Hit Wall Street With Takeover Wave*, WALL ST. J., Mar. 27, 1995, at C1 (discussing reform of Glass-Steagall Act as offered by Rep. James Leach, Sen. Alfonse D'Amato, and the White House, and predicting consolidations of banks and securities companies should Glass-Steagall Act be repealed); Banking Act of 1933, Pub. L. No. 73-66, §§ 16, 20, 21, 48 Stat. 162 (codified as amended in scattered sections of 12 U.S.C. and collectively referred to as Glass-Steagall Act).

124. *See* Cargill & Todd, *supra* note 8, at 68. The Financial System Research Council and the Securities and Exchange Council represented interests of the banking and securities industries. *Id.* at 68 n.74. Advisory councils are ad hoc committees attached to the Japanese ministries. *Id.* at 68 n.73. Their purpose is "to investigate, to debate and to advise the ministry on whatever issues may be referred to it." *Id.* The councils usually represent a cross-section of interests that could be affected by the measures to be considered. *Id.*

125. *Id.* at 68.

126. Law Concerning the Realignment of Relevant Laws for the Reform of the Financial System and the Securities Trading System, Law No. 87 of 1992 (Japan), *translated in, The Amendment to the Securities and Exchange Law to Insure the Fairness of Securities Trading* (Part I), CAMRI REV., Apr. 1992, at 2 [hereinafter Financial Systems Reform Law]; Cargill & Todd, *supra* note 8, at 71-72.

127. Financial Systems Reform Law, arts. 43-2, 65-3; *see* Cargill & Todd, *supra* note 8, at 71 n.93 (noting that banks owning less than majority of shares of subsidiary save expenses by establishing securities subsidiaries in conjunction with other shareholders).

128. Financial Systems Reform Law, art. 65, (2), items (2)-(4). Commercial paper and certain loan trusts are no longer subject to prohibitions of Article 65. Cargill & Todd, *supra* note 8, at 71-72. Furthermore, the law authorizes banks to deal with private placements in other securities. *Id.* at 72. Private placements are sales of securities to purchasers who are "qualified institutional investors." *Id.* at 72 n.97. A transaction qualifies as a private placement if there is little risk that securities will be transferred to the public by a public offering or to investors other than qualified institutional investors. *Id.* Commercial paper represents short-term promissory notes with different maturities, ranging from one month to six months. TATEWAKI, *supra* note 15, at 71. Banks and securities firms act as brokers in the commercial paper market. *Id.*

129. *See* SEL, Law No. 25 of 1948, art. 2.1(9) (Japan) (defining securities as those that may be "prescribed by a Cabinet order"). The term "securities" is narrowly defined in the SEL, which provides a specific list of bonds, stock shares, and various trust certificates. SEL, Law No. 25 of 1948, art. 2 (Japan). One author notes that Article 2.1(9) of

specifically enumerated as securities.[130]

2. Regulatory Bodies and the Structure of the Japanese Capital Markets

The MOF, modeled after the Securities and Exchange Commission[131] ("SEC") in the United States, exercises control over the Japanese economy.[132] In 1992, the Securities and Exchange Surveillance Commission[133] ("SESC") was established to aid the MOF in supervising securities and financial futures transactions by securities firms.[134] Together, the agencies supervise the securities firms,[135] which execute most of the securities business in Japan,[136] the capital market,[137] and the financial futures mar-

---

the SEL would leave open room for an expansive definition of "securities," but no new securities have been identified by the MOF under this provision. Hideki Kanda, *Politics, Formalism, and the Elusive Goal of Investor Protection: Regulation of Structured Investment Funds in Japan*, 12 U. PA. J. INT'L BUS. L. 569, 573 (1992).

130. Cargill & Todd, *supra* note 8, at 72. Since "securities" are narrowly defined, Article 65 is implicated when new securities products are introduced, requiring examination by the the Securities and Banking Bureaus of the MOF. Cargill & Todd, *supra* note 8, at 67. In 1990, securities firms could offer a variety of new foreign exchange-related products previously reserved to banks and securities products that combined commodity and currency futures with real estate, stocks, and bonds. Kyle Pendragon, *Japanese Banks Flourish Under Article 65 Rules*, FUTURES, Aug. 1990, at 53.

131. Milhaupt, *supra* note 21, at 444. The U.S. SEC was created under the Exchange Act. 15 U.S.C. § 78d (1988 & Supp. V 1993). The SEC is the federal agency that administers the securities laws in the United States. SCOTT, *supra* note 1, at 315.

132. *See* Milhaupt, *supra* note 21, at 460-61. The MOF supervises the activities of all financial institutions in the private and public sectors, sets monetary policy, organizes the government budget, and leads international negotiations in defining the Japanese financial markets. TATEWAKI, *supra* note 15, at 175. The MOF's power is so comprehensive that "[n]othing may happen without approval, either implicit or explicit, from the MOF." *Id.*

133. SEL, Law No. 25 of 1948, art. 56 (Japan) (delegating authority to Securities and Exchange Surveillance Commission ("SESC") to order securities firms to report all of their transactions and business operations, as provided for in Article 55). The agency was established on July 20, 1992, and aids the MOF in enforcement of antifraud rules and oversight of securities firms. Milhaupt, *supra* note 21, at 470. "The 1991 amendment primarily addressed the problem of compensation arrangement for losses. . . . While under the previous system, only the guaranteeing of compensation was against the law, the amendment made compensation per se illegal." Hiroshi Oda, *Latest Developments of the Securities and Exchange Law*, *in* JAPANESE COMMERCIAL LAW IN AN ERA OF INTERNATIONALIZATION 125, 138 (Hiroshi Oda ed., 1994).

134. SEL, Law No. 25 of 1948, art. 55 (Japan); Milhaupt, *supra* note 21, at 470; *see supra* note 3 (defining financial instruments called futures).

135. *See* VINER, *supra* note 11, at 15-19. The Big Four securities firms represent the major firms in Japan, followed by the second and third tiers of smaller securities firms. *Id.* at 15.

136. *See* TATEWAKI, *supra* note 15, at 133. Other private financial institutions in

ket.[138]

a. Financial Institutions and the Regulatory Framework

Although Japan possesses a tightly-regulated economy,[139] the MOF's enforcement strategy relies foremost on informal cooperation, rather than on formal enforcement through litigation.[140] Initially predicated on the role of the SEC in the United States,[141] the MOF has diverged from SEC precedence.[142] The MOF's informal stance contrasts with the SEC's formal enforcement objectives,[143] and the MOF undertakes greater responsibility than the SEC.[144]

Japan include insurance companies, securities investment trust management companies, and brokers in money markets and foreign exchanges. *See id.* at 128-40 (discussing private financial institutions in Japan).

137. *Id.* The Japanese capital market comprises the securities markets, which consist of the bond market and the stock market. *Id.*

138. *See supra* note 3 and accompanying text (noting beginning of futures trading in Japan in 1985).

139. *See supra* notes 8, 20 (explaining how Japan has refused to remove barriers in markets, despite rapid change since 1970's, for fear of unleashing resources in unregulated environment such as private sector).

140. Milhaupt, *supra* note 21, at 444. Japanese securities regulation is de-emphasized by regulators within the MOF because of the societal propensity toward cooperation in all aspects of the economy. *See* FRANK K. UPHAM, LAW AND SOCIAL CHANGE IN POSTWAR JAPAN 198 (1987). In 1981 an agency sponsored a study in which each major central government agency and many local governments were asked to "report on their use of informal administrative guidance." *Id.* The consensus by those polled indicated that "informality is preferred by every level of government and in all areas of government-citizen contact." *Id.* Despite this informality, the public defers to the MOF's power without compromise: "[The MOF] is perceived, both by itself and by the public, as the nation's most elite civil service, as guardian of the nation's economic health . . . in short, as the pinnacle of the Japanese state . . . ." Milhaupt, *supra* note 21, at 444.

Makoto Yazawa, once Professor of Law at the University of Tokyo, regarded the lack of enforcement authority as integrally connected to the traditional way of life in Japan. Yazawa, *supra* note 13, at 26. He advocated that power be concentrated in an independent agency similar to the U.S. SEC so as to effect better control over the rapidly changing financial markets. *Id.*

141. *See supra* note 87 (explaining MOF's original similarity to SEC in United States).

142. Milhaupt, *supra* note 21, at 445.

143. *See id.* at 445. The MOF relies on "administrative guidance," or informal enforcement to achieve regulatory objectives. *Id.* By contrast, the SEC's enforcement strategy emphasizes administration of financial institutions' disclosure practices and enforcement of antifraud provisions in the U.S. securities laws. Walter Werner, *The SEC as a Market Regulator*, 70 VA. L. REV. 755, 782-83 (1984).

144. *Id.* at 446. The MOF has jurisdiction over the raising and expenditure of public funds as well as the banking, securities and insurance industries. *Id.*; *see supra* note 132 (explaining MOF's supervision of financial institutions, monetary policy,

Using Article 8 of the National Government Organization Law,[145] the Japanese government created the SESC[146] in order to reduce the enormous responsibilities undertaken by the MOF.[147] The SESC conducts investigations into violations of antifraud rules and inspects securities companies, securities exchanges, and the Japan Securities Dealers Association.[148] The SESC evolved out of the government's recognition of the need for reform in the Japanese capital markets.[149] The SESC remains hampered, however, by weak enforcement capability and a traditional view of securities regulation based on informal cooperation.[150]

The MOF and SESC jointly regulate the securities firms,

---

budget, and international financial negotiations); Milhaupt *supra* note 21, at 446 (explaining "sweeping range of MOF's jurisdiction," and comparing MOF's "conflicting roles as overseer of the national budget and regulator of the entire financial industry" to smaller responsibilities of SEC and other regulatory agencies in United States).

145. Kokka Gyosei Soshiki Ho [National Government Organization Law], Law No. 120 of 1948. "Article 8 bodies—such as the SESC—generally lack substantial formal powers and remain under the ultimate control of the ministry with which they are affiliated." Milhaupt, *supra* note 21, at 469 n.216.

146. *See supra* note 133 (maintaining that SESC aids MOF in supervising securities transactions).

147. Milhaupt, *supra* note 21, at 490. The securities scandals in Japan, in 1991, revealed the ineffectiveness of the MOF as the primary regulator of securities transactions. *See id.* at 466-67 (explaining that scandals triggered "intensive public scrutiny" of Japanese securities regulation). The SESC was established in recognition of the enormous responsibilities assumed by the MOF, and in an effort to improve monitoring of such transactions. *Id.* at 467. The securities scandals involved illegal payments by securities firms to institutional investors who lost money in the markets during 1990. *Id.* at 460-61. The incidents led to MOF-sponsored sanctions, lawsuits by small investors, and renewed scrutiny of the securities industry. *See generally id.* at 459-67 (discussing background and effects of securities scandals).

148. *Id.* at 470. The Japan Securities Dealers Association is an organization of securities companies, created to impose a self-regulatory mechanism in the Japanese markets. VINER, *supra* note 11, at 333. This resembles the National Association of Securities Dealers ("NASD") in the United States, which was established in 1939 to regulate the markets not associated with any of the stock exchanges. SCOTT, *supra* note 1, at 225. The NASD is comprised of brokers and dealers responsible for regulating themselves. *Id.*

149. Milhaupt, *supra* note 21, at 472; *see supra* notes 133, 145-47 and accompanying text (explaining origin of SESC after securities scandals in 1991 in Japan).

150. Milhaupt, *supra* note 21, at 480. The existing realities of administrative powers within Japan limit the enforcement capability of the SESC. *Id.* The history of securities regulation in Japan, coupled with the circumstances under which the SESC was established, give rise to three questions: "Does . . . [it] have sufficient powers to accomplish its substantial tasks? Will the placement of the SESC within MOF undermine its role as market monitor? And . . . does its establishment represent a shift in regulatory stance away from informal, promotional policies toward formal market regulation

which execute most of the securities business in Japan.[151] Securities firms play the central role in Japanese securities markets,[152] engaging in dealing,[153] brokerage activities,[154] underwriting,[155] and selling of stocks and all types of bonds.[156] The Big Four

---

grounded in the SEL?" *Id.* at 472; *see id.* at 466-80 (analyzing SESC's role as new administrative arm of MOF).

151. TATEWAKI, *supra* note 15, at 133.

152. *Id.*; *see supra* notes 135-36 and accompanying text (explaining that Big Four securities firms and second- and third-tier firms comprise financial institutions dealing in most securities business in Japan).

In addition to securities firms, securities finance companies, peculiar to Japan, provide equity and bond financing through the major stock exchanges. VINER, *supra* note 11, at 38. They extend loans to companies listed on the stock exchanges as well as to securities companies and the securities companies' clients. *Id.* Although they provide a necessary link between the securities and the money markets, they may gradually disappear as the financial markets are liberalized. *Id.* at 39. If the provisions of Article 65, SEL, Law No. 25 of 1948, art. 65 (Japan), continue to be relaxed in favor of more integration between banks and securities companies, financing will be facilitated, thereby obviating the need for the finance companies. *Id.* At present, there are three major companies, the Japan Securities Finance Company, the Osaka Securities Finance Company, and the Chubu Securities Finance Company. *Id.* at 38. "Money market" is defined as the market for trading short-term, low-risk securities, and is usually comprised of dealers linked by electronic communications rather than by the exchanges. SCOTT, *supra* note 1, at 217.

153. *See supra* note 113 (defining dealer).

154. *See id.* at 38. A "broker" is "[a]n individual or a firm that brings together buyers and sellers but does not take a position in the asset to be exchanged." *Id.* Many firms operate as broker-dealers, performing both services depending upon different variables, such as market conditions and the size, type, or security involved. *Id.* at 87. A broker, rather than a dealer, is more likely to form an unbiased opinion on a security because there is no economic interest involved in executing a transaction for an investor. *Id.* at 38.

155. *See supra* note 114 (defining underwriter).

156. TATEWAKI, *supra* note 15, at 133. Each securities firm must obtain a license to practice in each type of business from the MOF. *Id.* Prior to World War II, securities firms were small, mainly because *zaibatsu* conglomerates executed most of the stock trading as they held most of the equity. VINER, *supra* note 11, at 14; *see supra* notes 33-34, 38 and accompanying text (discussing domination of *zaibatsu* during pre-World War II period). After World War II, securities companies acted as brokers in the stock and bond markets, areas from which the banking industry was absolutely excluded. VINER, *supra* note 11, at 7; *see supra* notes 112-20 and accompanying text (explaining separation of securities operations from banking operations in Japan by virtue of Articles 65 and 43 of SEL and Article 10 of Banking Law). During the post-World War II period, the Japanese stock market emerged as a favored place in which individuals chose to invest their money. VINER, *supra* note 11, at 14. In 1949, individuals held a majority of shares of corporations, totalling approximately 69.1%. *Id.* Thereafter, the MOF encouraged mergers of securities firms in order to prevent bankruptcies of existing small firms. *Id.* The MOF reduced the number of registered securities firms from 1152 in 1949 to 244 at the end of March 1986. *Id.* As a result, the MOF reorganized the securities firms into three tiers within Japan. *Id.* at 15.

securities firms[157] control a majority of the market for underwriting, followed by two tiers of smaller companies.[158] The second tier, comprised of ten significantly smaller companies,[159] relies heavily on brokerage commissions from securities trading, as does the third tier of registered securities firms.[160] In addition, many of the second- and third-tier firms are affiliates or satellites of the Big Four firms.[161] Lastly, the three-tier structure of securities firms in Japan is compromised by a growing category of non-Japanese securities firms.[162]

b. Structure and Laws of the Capital Markets

After 1975, the Japanese securities markets expanded, as a result of the large-scale flotation of government bonds,[163] the internationalization of finance,[164] and the innovation[165] that ac-

157. VINER, *supra* note 11, at 15. The Big Four, Nomura, Daiwa, Nikko, and Yamaichi, rank among the six biggest securities firms in the world. *Id.* Part of the Big Four's success derives from their marketing techniques, which they learned from U.S. investment firms in the 1960's. *See id.* at 18-19 (noting that salaried salesmen specifically target wealthy taxpayers by frequently consulting references published by Tax Bureau, and that each firm maintains over 100 domestic sales offices with thousands of sales personnel).

158. *Id.* at 15.

159. *See* STEPHEN BRONTE, JAPANESE FINANCE: MARKETS AND INSTITUTIONS 79-80 (1982). The largest of the smaller second-tier companies is New Japan Securities. *Id.* at 79. The second-tier companies depend on stock brokerage and dealing, rather than underwriting, for the major portion of their income. *Id.* at 80.

160. VINER, *supra* note 11, at 15. Unlike the second-tier firms, the third-tier companies are too small to qualify for underwriting licenses. BRONTE, *supra* note 159, at 80. The third-tier companies possess individual clients and lack comprehensive research facilities. *Id.*

161. VINER, *supra* note 11, at 15. There are 93 total securities firms in Japan: six are non-Japanese; four are the Big Four; 10 are second-tier firms; 73 are third-tier firms. *Id.* Thirty of the smaller firms are affiliated with Nomura, 19 are affiliated with Yamaichi, and a portion of the remainder are affiliated with banks. *Id.*

162. *Id.* at 16. For example, Salomon Brothers, a U.S. securities firm, was the 11th largest security firm in Japan in 1986 in terms of operating profits, and was the third largest trader in the bond futures market. *Id.* Merrill Lynch, another U.S. securities firm, became the first non-Japanese firm to list its shares on the Tokyo Stock Exchange in November 1986. *Id.*

163. *See* TATEWAKI, *supra* note 15, at 17. Government bonds were sold to enable the government to raise money and finance the large public sector deficit. *Id.*; *see supra* notes 95-100 and accompanying text (explaining increase in government and public sector deficits during 1970's resulting from oil crisis, and subsequent aid of banks in bailing out government's debt). The increase in government bonds added volume to the trading markets for bonds, which resulted in the development of direct finance through the securities market. TATEWAKI, *supra* note 15, at 17.

164. *See supra* notes 25, 102 and accompanying text (explaining Japan's achieve-

companied deregulation in the markets.[166] The period following 1975 marked the diversification of financial assets along with an increase in investors from banks to institutional investors,[167] individuals, and non-Japanese persons.[168] In order to handle the changes in the capital markets, a committee appointed by the MOF sought to revise the definition of "securities" in 1988.[169] Although no changes occurred, the committee recognized that securities companies were forbidden from conducting a business other than securities business.[170]

Most securities transactions between parties other than the issuer take place on the Japanese stock market, which includes

---

ment of rank of second in world in GNP, which caused Japan to lower barriers to Japanese markets in order to aid development of international transactions).

165. *See* TATEWAKI, *supra* note 15, at 46. Development of new financial products increased as life insurance companies, securities firms, and other financial institutions participated in the growing capital markets. *Id.*

166. *Id.* at 17-20. During the pre-World War II period, banks possessed the dominant role in providing funds because of the rapid industrialization and the shortage of investment funds. SECURITIES MARKET IN JAPAN, *supra* note 36, at 14. After World War I, the development of heavy industries resulted in the extensive expansion of the stock and bond markets. *Id.*

167. *See* WOELFEL, *supra* note 95, at 596-97. An "institutional investor" signifies an entity that trades in securities in such large quantities that it gains preferential treatment and obtains lower commission rates. *Id.* at 596. Regulations usually do not apply to these entities because they are presumed to be more knowledgeable and able to protect themselves against fraud. *Id.* at 596-97. Examples of institutional investors in most financial systems include pension funds, mutual funds, insurance companies, unions, and other organizations that trade securities in bulk quantities. *Id.* at 597.

168. TATEWAKI, *supra* note 15, at 82.

169. Shigeki Morinobu, *Review of Securities Regulation in Japan, in* Capital Markets and Financial Services in Japan 8, 12 (1992). Shigeki Morinobu, the Director for International Affairs of the Securities Bureau of the Ministry of Finance, stated: "Abundant Japanese capital, which is supported by high savings ratio, is needed everywhere in the world. For our capital market to meet these demands and supply the funds smoothly, the review of the basic system is necessary." *Id.* at 11. The Securities and Exchange Council, an advisory body to the MOF, created the Fundamental Research Committee in September 1988 to study the Japanese capital market. *Id.* They deliberated over changes in the structure of the capital market "based upon the standards of efficiency, internationality, soundness and stability." *Id.* at 11-12.

170. *Id.* at 13. Specifically, the committee proposed to widen the role of institutions other than securities firms by allowing them to partake in transactions involving securitized products that are not explicitly defined in the SEL. *Id.* "Therefore it is proposed that those who engage in a business other than securities business should be allowed to engage themselves in certain securitized products by introdu[cing] a limited license system." *Id.* This proposal recognized the innovation that had created new products that, although resembling securities, did not fall within the definition of securities under the SEL. *Id.*

trading in the secondary market.[171] The secondary market is divided between those transactions that occur at the stock exchange and those that take place over the counter ("OTC").[172]

171. TATEWAKI, *supra* note 15, at 82; *see* SCOTT, *supra* note 1, at 312. The "secondary market" comprises trading of existing securities among investors, usually through an intermediary, such as a broker. *Id.* The primary market, in contrast, comprises issuers, subscribers (those who reserve the right to purchase securities from the issuers), and intermediaries who act as the brokers between issuers and subscribers. TATEWAKI, *supra* note 15, at 81. The intermediaries include underwriters and trustees. *Id.* The trustees are of two types: for subscription and for collateral. *Id.* at 82. The former are entrusted by the issuer to deal with necessary clerical work concerning the subscription of an issue of corporate bonds. *Id.* The latter administer collateral that is attached to a collateralized bond on behalf of the bondholder. *Id.* "Collateral" is any asset pledged as security for a loan, entitling the lender to sell such collateral in the event of default by the borrower. SCOTT, *supra* note 1, at 62-63. Article 65 of the SEL prohibits underwriting business to financial institutions other than securities firms except the markets for government bonds, municipal bonds, and government-guaranteed bonds. SEL, Law No. 25 of 1948, art. 65.2(2)(a) (Japan); *see supra* note 91 (identifying and explaining same provision in SEL); TATEWAKI, *supra* note 15, at 81-82. In general, corporate securities are underwritten only by securities firms. *Id.*

172. *Id.* at 82. The over-the-counter ("OTC") market is a large aggregation of dealers who make markets in securities. SCOTT, *supra* note 1, at 252. In contrast to an exchange that is a physical location where trading occurs, OTC trading is effected through telephone or computer. *Id.* Without formal regulations of an exchange, OTC markets tend to be more speculative because of the lack of a standard price. *Id.* An individual or dealer "makes a market" by quoting prices at which securities may be bought or sold. *Id.* at 207.

The Securities Research Institute noted the chief characteristics of the exchange market:

> (1) Prices are consecutively determined every day when the sessions are held.
> (2) There exists a fixed market where the parties to the transactions can gather.
> (3) Trading is limited to members, who are required to possess certain qualifications.
> (4) Trading is limited to listed stocks that have met certain basic standards.
> (5) In connection with the trading of the listed stocks, the system of a centralized market is adopted so that buy and sell orders may converge on the market, and the trading contracts are concluded based upon the principles of competitive bidding.
> (6) In order to simplify the settling of accounts, a system of clearing accounts has been adopted.
> (7) To assure fairness in trading, the exchange reserves the right to supervise the trading by enacting appropriate regulations.

SECURITIES MARKET IN JAPAN, *supra* note 36, at 41-42. The Institute also characterized the OTC market:

> (1) Transactions are executed over the counter of securities firms;
> (2) it has no fixed marketplace; it exists only in the abstract;
> (3) trading is conducted through negotiations between a buyer and a seller;
> (4) because prices are determined through isolated negotiations, they could vary from one firm to another; and

Because OTC transactions in stocks promote unstable prices, stocks listed on an exchange may not be traded OTC.[173] Over the counter trading in bonds, which is permitted, is more prevalent[174] than trading in stocks, which is concentrated at the stock exchanges.[175] The stock exchanges are corporations that are organized in order to comply with the SEL, with membership limited to securities firms.[176] Currently, there are eight exchanges, with the Tokyo Stock Exchange ("TSE") conducting nearly eighty percent of total trading volume of all exchanges, and the Osaka Exchange ("OSE") carrying fifteen percent of the volume.[177] In October 1985, the bond futures market was added to the TSE.[178]

The Financial Futures and Exchange Law[179] ("FEL"), together with the revision of the SEL in 1988,[180] subjected Japan's

---

(5) equity issues tradable over the counter, in principle, must be those registered with the Japan Securities Dealers Association.

Id. at 42; *see* ISAACS & EJIRI, *supra* note 72, at 29 (noting characteristics of each market).

173. *See supra* note 172 (discussing lack of standard prices in OTC market).

174. *Id.* at 83. Approximately 95% of the trading volume in bonds occurs over the counter. *Id.*

175. TATEWAKI, *supra* note 15, at 82-83.

176. *Id.* at 82.

177. *Id.* The other six exchanges are in Nagoya, Kyoto, Hiroshima, Fukuoka, Niigata, and Sapporo. *Id.* After the post-World War II boom in equities and increase in the amount of transactions in non-listed stocks, a second section of the stock exchanges was created in 1961, jointly listed by the stock exchanges in Tokyo, Osaka, and Nagoya. *Id.*

178. *Id.* at 83; *see supra* note 3 (discussing introduction of Japanese Government bond futures contract on TSE as advent of financial futures market in Japan).

179. FEL, Law No. 77 of 1988 (Japan) (revised in 1992) (Survey Japan trans., 1992). In addition, the FEL applies to financial futures and options contracts not derived from securities, which are covered under the SEL. *Id.* art. 2.4; *see* SEL, Law No. 25 of 1948, art. 1 (Japan) (defining SEL as applying to "buying and selling of, or other forms of transactions in, securities").

180. SEL, Law No. 25 of 1948 (as amended to 1988) (Japan). Prior to amendment, the SEL was compromised in response to the MOF's introduction of stock futures trading in mid-1987. Brian Semkow, *Japan's Derivative Financial Products Markets*, 7 INT'L. FIN. L. REV. 29, 29 (Dec. 1988). The Osaka 50-Stock Futures Contract ("OSF 50") had to comply with existing law, which only permitted physical delivery of stocks, not cash settlement. *Id.* To satisfy investors wishing to hedge against fluctuations in prices of stock holdings, the MOF approved trading in the OSF 50. *Id.* In order to satisfy the SEL, however, the OSF 50 was composed of 225 representative stocks of the TSE's Nikkei average, which allowed physical delivery of the basket of stocks upon expiration of the futures contract. *Id.* For example, investors could hedge against declines in value of their stock holdings by selling stock index futures, thus locking in a future price at today's prices. *Id.* at 30. The term "hedge" identifies a position taken to offset the risk associated with some other position. *See* KAPNER & MARSHALL, *supra* note 1, at 501.

futures and options markets to a legal structure within the secondary market.[181] Equity derivative[182] markets were launched with the inception of Tokyo Stock Price Index ("TOPIX") in September 1988 in order to consolidate and expand futures and options trading.[183] The TOPIX and 225 share Nikkei Stock Average index allow cash settlement[184] instead of physical delivery of the stocks on the index.[185] The revised SEL also created a market for stock index futures[186] and options.[187] Options were introduced to enable investors to hedge and limit downside risk[188] and also to achieve profits.[189]

Usually, the initial position is a cash position (such as the purchase of a stock) and the hedge position involves a risk-management instrument such as a future. *Id.*

181. Aoki, *supra* note 3, at 223.

182. *See supra* note 1 (defining "derivative instruments").

183. ISAACS, *supra* note 123, at 2; Semkow, *supra* note 180, at 30.

184. *See* SEL, Law No. 25 of 1948, art. 2.14 (Japan). Article 2 permits parties to enter into a transaction based on the value of a securities index. *Id.* The parties may settle their transaction on a future date by paying cash. *Id.* Cash settlement reconciliates the difference between the numerical value of the index as agreed to in advance and the numerical value of the index prevailing on the contract date. *Id.*

185. Semkow, *supra* note 180, at 30; *see supra* note 180 (describing how SEL, prior to its revision in 1988, only permitted physical delivery of stocks and not cash settlement of transactions). The Tokyo Stock Price Index ("TOPIX") and 225 share Nikkei Stock Average index ("Nikkei 225") compete with the OSF 50. *Id.* Because cash settlement is required on TOPIX and Nikkei 225, however, the OSF 50 has become more cumbersome. *Id.*; *see supra* note 180 (explaining that OSF 50 requires physical delivery of stocks upon expiration of contract).

186. *See* Thomas A. Russo, *Regulation of Equity Derivatives*, *in* SWAPS AND OTHER DERIVATIVES IN 1994, at 595, 601 (PLI Corp. Law & Practice Course Handbook Series No. B-848, 1994). "Stock index futures" provide for payment obligations based on the value of a stock index, rather than a change in that index, as of a given date. *Id.*

187. *See* SEL, Law No. 25 of 1948, art. 2.13 (Japan) (defining "trading in securities futures" as transactions in which parties prescribe payment of cash to settle difference between contract price and price prevailing on date of settlement). Stock, or equity, index options grant their holders payments based on changes in the value of a stock index. Daniel P. Cunningham et al., *An Introduction to OTC Derivatives*, *in* SWAPS AND OTHER DERIVATIVES IN 1994, at 121, 128 (PLI Corp. Law & Practice Course Handbook Series No. B-848, 1994). The transaction involves one party that grants to another party—in consideration for payment of a premium—the right "to receive a payment equal to the amount by which an equity index either exceeds (in the case of a call) or is less than (in the case of a put) a specified strike price." *Id.*

188. *See* KAPNER & MARSHALL, *supra* note 1, at 495. "Downside risk" focuses only on possible negative results that may occur as an expected outcome, "as opposed to risk more generally which includes any deviation, either positive or negative." *Id.*

189. ISAACS, *supra* note 123, at 221. MOF permitted Japanese financial institutions to trade options on specific instruments, such as U.S. government bonds and interest rates, on overseas exchanges. Semkow, *supra* note 180, at 30-31.

B. *Derivative Instruments: Introductory Concepts*

The use of derivatives resembles the purchase of an insurance policy.[190] Many types of derivative products, including the swap product,[191] exist to satisfy investors' needs to hedge against the risk of loss from their investments.[192] The variable combinations of derivatives are reducible to the forward-based product[193] and the option-based product.[194] Despite the value of derivatives as tools for risk management, derivatives use involves basic forms of financial risks.[195]

1. Features of Derivatives and Basic Products

Derivative products provide businesses and institutional investors with a tool for insulating their investments against poten-

---

190. Patrick H. Arbor, *Derivatives are Just Like 3 Pieces of Mom's Apple Pie*, CHI. TRIB., Jan. 23, 1995, at 13N. For example, a car owner purchases automobile insurance to protect against possible collision damage or destruction of the car, while homeowners buy insurance in the case of fire or storm damage. *Id.* Likewise, investors can buy "insurance," in the form of derivatives, to protect against losses caused by fluctuations in the world's interest rate, currency, commodity and equity markets. *Id.*

191. *See* John Andrew Lindholm, *Financial Innovation and Derivatives Regulation—Minimizing Swap Credit Risk Under Title V of the Futures Trading Practices Act of 1992*, 1994 COLUM. BUS. L. REV. 73, 79 (1994). In a "plain vanilla" or "classic" interest rate swap, the borrower and the investor exchange fixed- for floating-rate financing, with the floating rate usually based upon the London Interbank Offered Rate ("LIBOR"). *Id.*; *see supra* note 17 (defining differences between fixed and floating rates of exchange). The LIBOR is the basic short-term rate of interest in the Eurodollar market, similar to the prime rate in the United States. SCOTT, *supra* note 1, at 203; *see generally* KAPNER & MARSHALL, *supra* note 1, at 3-35 (discussing, in detail, swap product and its origin).

192. U.S. GENERAL ACCOUNTING OFFICE, FINANCIAL DERIVATIVES: ACTIONS NEEDED TO PROTECT THE FINANCIAL SYSTEM 34 (GAO/GGD-94-133, May 1994) [hereinafter GAO REPORT] (noting that derivatives use has expanded globally to a notional amount of US$12.1 trillion because of "need for products to address the risk of volatile interest and exchange rates and prices"). The notional value represents the amount of principal that, although never actually changing hands, is the basis upon which the interest on a swap or related instrument is calculated. KAPNER & MARSHALL, *supra* note 1, at 508. Because notional principle refers to the sums underlying the derivatives contracts, not the income streams that counterparties are bound to exchange, it is an inaccurate proxy for market value. *See* Henry T.C. Hu, *Misunderstood Derivatives: The Causes of Informational Failure and Promise of Regulatory Incrementalism*, 102 YALE L.J. 1457, 1459 n.6 (1993) (noting that figures are usually used because numbers are readily available).

193. *See* Kenneth A. Froot et al., *A Framework for Risk Management*, HARV. BUS. REV., Nov.-Dec. 1994, at 91, 99. A forward obligates the user to buy or sell an asset for a specified price on a specified future date. *Id.*

194. *Id.* An option enables the user to choose whether to buy or sell the underlying asset on which the option is based at a specific price on a specific date. *Id.*

195. Carol J. Loomis, *The Risk That Won't Go Away*, FORTUNE, Mar. 7, 1994, at 40, 43-44.

tial losses.[196] In addition, derivatives contracts may produce escalating profits.[197] Derivatives dealers, the lead actors comprised of the large commercial banks and the major securities firms, represent the parties on one side of the contract in search of potential profits.[198] The other side of the contract consists of end users,[199] who may be the dealers themselves, or institutional investors capable of taking the risks associated with derivatives.[200] Investments in derivatives can also be more cost-effec-

196. Arbor, *supra* note 190, at 13N. For example, if an investor wants to purchase value in the General Electric Company ("GE"), instead of buying the company's stock, he may buy a "call" on GE, an option entitling the investor to buy GE at a specified future time at a specified price. Loomis, *supra* note 195, at 43. The value of the call, or the derivative, will be determined by what happens to the price of the GE stock, which is the underlying asset. *Id.*; *see supra* note 1 (defining "underlying asset"). The cost of the call, or the premium, provides great "leverage" if the stock does well. Loomis, *supra* note 195, at 43. If the stock falls, the call is worthless. *Id.* "Leverage" involves the use of any financial instrument or mechanism "to magnify potential returns with concomitant magnification of financial risk." KAPNER & MARSHALL, *supra* note 1, at 505. For example, the use of futures and options provides leverage. *Id.*

197. Loomis, *supra* note 195, at 40. Derivative contracts can produce growth rates of 40% a year for some users. *Id.* "They demand superlatives, are measured in trillions of dollars, are quintessentially global, and are positioned on what wags call 'the bleeding edge of technology.' " *Id.* Speculators seeks to profit from valuation changes in derivatives or their underlying assets. GAO REPORT, *supra* note 192, at 25. "Rather than owning the underlying [asset], speculators can use derivatives as a more affordable way to attempt to profit from anticipating movements in market rates and prices." *Id.* Speculators add liquidity to the financial market, as they enter into transactions with hedgers and other speculators, because their investments ensure high volumes of trading without significant price changes. *Id.*; *see supra* note 81 (defining liquid).

198. *Id.* The OTC market offers greater contractual freedom than on exchanges because the parties can individually customize their contracts, rather than conforming them to standardized rules of an exchange. Hu, *supra* note 192, at 1465. The OTC market consists mainly of sophisticated investors, like corporations and other sovereign entities, who "negotiate directly with industrial corporations, financial institutions, or money center banks." *Id.*

199. Loomis, *supra* note 195, at 40. "End users hedge market risks by investing in derivatives, which counter adverse price movements." Hu, *supra* note 192, at 1466. In addition, end users can "arbitrage between the price of the derivative and the market price of the underlying asset or between prices in different capital markets." *Id.* The end users are also known as "counterparties" to the contract. Loomis, *supra* note 195, at 41; *see supra* note 40 (defining arbitrage).

200. Loomis, *supra* note 195, at 40. Private individuals are usually unable to enter into derivative transactions with dealers, such as banks. Hu, *supra* note 192, at 1465 n.29. The average contract size for derivative transactions known as interest rate swaps at year end 1991 was US$30 million. *Id.*; *cf. Salomon Forex v. Tauber*, 795 F. Supp. 768 (E.D. Va. 1992) (illustrating example of wealthy individual involved in OTC currency options). "Interest rate swaps" are individually negotiated agreements between a dealer, such as a bank, and end user, such as a corporation, involving an exchange of interest rate payments. Hu, *supra* note 192, at 1467 n.44. For example, a corporation

tive than partaking in transactions in the underlying cash markets because derivatives offer reduced transaction costs and increased leverage capabilities.[201]

Derivative instruments transfer risks and increase investment opportunities otherwise inaccessible by selected purchases of the underlying assets.[202] Although the definition of derivatives includes such complex products as collateralized mortgage obligations,[203] regulators generally focus on the basic contracts such as swaps,[204] options,[205] and futures.[206] Forward-based contracts and option-based contracts constitute the two building blocks for all derivative products.[207]

A forward is the most basic type of derivative, in which a user promises to buy or sell an asset for a specified price on a specified date.[208] There are four primary features of forward

---

issues US$100 million of debt securities that mature in five years, and pay a floating interest rate. *Id.*; *see supra* note 17 (defining floating exchange rate). The corporation can hedge against the possibility of rising interest rates by entering into an interest rate swap with a bank. Hu, *supra* note 192, at 1467 n.44. The corporation agrees to pay the bank a fixed seven percent interest on the amount of US$100 million every year for five years. *Id.* In return, the bank pays the corporation interest on the same amount, called the "notional amount," equal to the prime rate every year for five years. *Id.*; *see* Henry T.C. Hu, *Swaps, The Modern Process of Financial Innovation and the Vulnerability of a Regulatory Paradigm*, 138 U. PA. L. REV. 333, 347-53 (1989) (illustrating interest rate swaps with more extensive example).

201. GAO REPORT, *supra* note 192, at 25. A U.S. market participant can realize cost savings by buying or selling a derivatives contract based on the Standard & Poor's 500 Index ("S&P Index"). *Id.* at 26. Instead of "buying or selling all of the stocks in the [S&P Index]," the investor can purchase or sell the derivatives contract "for as little as 5 to 10 percent of the cost of the underlying stocks." *Id.*; *see supra* note 196 (defining leverage).

202. Lindholm, *supra* note 191, at 76.

203. *Id.* at 75. A collateralized mortgage obligation, or "CMO," is a bond backed by a "pool of whole mortgages or by mortgage pass-throughs which are classed according to expected maturity ranges at the time of issue." SCOTT, *supra* note 1, at 63. A "pass-through security" is a "security that passes through payments from debtors to investors." *Id.* at 255. The security is so named because "interest and principal payments made by borrowers are passed through monthly," after accounting for a service fee. *Id.* at 255-56. Generally, the greater certainty of payment size in a CMO is offset by lower returns based on the purchase price. *Id.* at 63.

204. *See supra* notes 191, 200 (discussing swap product).

205. *See supra* note 194 (defining options).

206. GAO REPORT, *supra* note 192, at 26; *see supra* note 3 (defining futures).

207. Froot, *supra* note 193, at 99.

208. *Id.*; Loomis, *supra* note 195, at 44. For example:

> [A] long forward position of 1,000 barrels of oil at a price of US$20 per barrel, with a one-year maturity, obligates the user to buy 1,000 barrels of oil (or its cash equivalent) one year hence for US$20,000. A short forward position obli-

contracts.[209] First, the gain earned from a forward contract when the value of the underlying asset moves in one direction equals the loss incurred if the underlying asset moves in the opposite direction.[210] Second, no money changes hands when the forward contract is initiated between the parties.[211] Third, the forward contract is settled at maturity.[212] Last, forward contracts are traded mainly in the OTC market, and thus may be customized for the user.[213] The most common type of forward contract is the swap contract.[214]

Unlike a party to a forward contract, the holder of an option may choose to buy or sell the underlying asset at a specified price on a specified date, but has no obligation.[215] The holder

---

gates the user to deliver 1,000 barrels of oil (or its cash equivalent) for US$20,000. Long positions enable hedgers to protect themselves against price increases in the underlying asset; short positions protect hedgers against price decreases.

Froot, *supra* note 193, at 99.

209. Froot, *supra* note 193, at 99.

210. *Id.*

211. *Id.*

212. *Id.*

213. *Id.*; *see supra* note 198 (discussing how investors may customize their contracts in OTC market).

214. Loomis, *supra* note 195, at 43; *see supra* notes 191, 200 (defining swap product). Swaps are packages of forward contracts, and share the same basic features. Froot, *supra* note 193, at 99. A company that issues floating-rate debt over ten years, requiring annual interest payments, can use a swap to convert its floating-rate obligation into a fixed-rate obligation, thereby hedging against future increases in the interest rate. *Id.* This swap is merely "a bundle of interest-rate forward contracts." *Id.*

Futures contracts also resemble forwards, except that they are "marked to market" on a daily basis. *Id.* The user pays cash to cover any losses on the transaction, and cash is paid to the user to reflect any profits. *Id.* The technique of marking to market reduces counterparty risk because each party's liability or profit is recorded and settled each day. *Id.*

215. *Id.* For example, "a call option on oil might grant the user the right to buy 1,000 barrels of oil at a price of US$20 per barrel anytime between now and one year hence. Conversely, with a put option, the user would have the right to sell the oil at the agreed upon price." *Id.*; *see* BERNSTEIN, *supra* note 40, at 203-30 (describing origin of options and variables used in pricing options under Black-Scholes Option Pricing Model). Bernstein recounts Aristotle's story of the philosopher Thales the Milesian who had exceptional skill in reading the stars:

> One winter he foresaw that the autumn olive harvest would be much larger than normal. He took the little money he had saved up and paid quiet visits to all the owners of olive presses in the area, placing small deposits with each of them to guarantee him first claim on the use of their presses when fall arrived. He was able to negotiate low prices, for the harvest was still nine months off, and, anyway, who could know whether the harvest would be large or small. . . . When the harvest-time came, and many [presses] were wanted all at once and

of a call option can profit a great deal if the price of the underlying asset rises.[216] If the price of the underlying asset falls, however, the holder will not exercise the option; the holder only loses the premium paid to the seller.[217] Unlike forwards, money is exchanged in the form of a premium paid to the seller in consideration for the buyer's right to allow the option to expire either before or on the maturity date.[218] In addition, options are settled when the holder exercises his right to purchase or sell the underlying asset, which may occur before the maturity date.[219] Finally, options are available both on exchanges and in the OTC market.[220]

Swaps are the most common OTC derivative and share the same risks as other OTC derivatives.[221] Swaps are contractual agreements between two counterparties, in which the parties agree to make periodic payments to each other.[222] The most common types of swaps are the interest-rate swap[223] and the currency swap.[224] Swaps have borne a host of variations designed to

---

of a sudden, he let them out at any rate he pleased, and made a quantity of money.

BERNSTEIN, *supra* note 40, at 203-04. "Aristotle's anecdote about Thales and his financial device is the first recorded mention of the instrument that has come to be known as an option." *Id.* at 204.

216. Froot, *supra* note 193, at 99; *see supra* note 215 (defining call option and put option).

217. *Id.*

218. *Id.*

219. *Id.*

220. *Id.*

221. *See* SATYAJIT DAS, SWAPS AND FINANCIAL DERIVATIVES 3-4 (1994) (describing prominence of swaps within global capital markets by illustrating size of swap market (US$4.6 trillion at end of 1992), variety of participants in swap market (including corporations and government financial institutions), and variety of uses for swap transactions). "[W]hat have really been burning up the track are OTC derivatives, the tailor-made contracts whose dazzling growth began in the mid-1980s . . . . These are the derivatives that are making the business so complex and difficult for regulators to get their arms around." Loomis, *supra* note 195, at 43.

222. KAPNER & MARSHALL, *supra* note 1, at 4. The swap agreement specifies "the currencies to be exchanged (which may or may not be the same); the rate of interest applicable to each (which may be fixed or floating); the timetable by which the payments are to be made; and any other provisions suitable to each party." *Id.*; *see supra* notes 191, 200 (discussing swap product).

223. *See supra* note 200 (defining interest rate swap).

224. KAPNER & MARSHALL, *supra* note 1, at 4. In the basic currency swap, "the two counterparties agree to an immediate exchange . . . of one currency for another at some exchange rate . . . . These currencies are later swapped back at the same exchange rate. In the interim, the counterparties exchange interest payments." *Id.* at 5.

serve special purposes for industrial corporations, financial corporations, banks, insurance corporations, and sovereign governments.[225] They are used to reduce the cost of capital, to manage risks, and to arbitrage[226] the world's capital markets.[227]

2. Risks Associated with Derivatives Trading

Users and dealers of derivative instruments encounter several types of risks in the marketplace, and then pass these risks to other parties connected to the derivatives contracts.[228] First, derivatives transactions may affect an entire financial system, creating systemic risk.[229] Second, the susceptibility of prices to volatile movements creates the possibility of market risk.[230] Third, a derivatives contract may create counterparty credit risk.[231]

---

225. *Id.* at xix.

226. *See supra* note 40 (defining arbitrage).

227. KAPNER & MARSHALL, *supra* note 1, at xix. "Clearly, it is difficult to overstate the importance of the swap markets to modern finance." *Id.*

228. Loomis, *supra* note 195, at 41. The risk is passed by the initial contract to a dealer, who then may hedge against this risk of loss with a separate contract with another dealer, who in turn may contract with a third dealer or a speculator who wants the risk. *Id.*

229. *Id.* at 41; *see* Hu, *supra* note 192, at 1502 (explaining interdependencies resulting from single derivative transaction that may cause systemic collapse, such as fragile payment networks of corporations and money center banks, banks' use of futures to offset derivative deals, and link between cash markets and swap markets). Carol Loomis imagines a crisis at a major dealer "that would cause it to default on its contracts and be the instigator of a chain reaction bringing down other institutions and sending paroxysms of fear through a financial market that lives on the expectation of prompt payments." Loomis, *supra* note 195, at 41. *But see* John Plender, *Through a Market Darkly: Is the Fear that Derivatives are a Multi-billion Dollar Accident Waiting to Happen Justified?*, FIN. TIMES, May 27, 1994, at 17 ("Most central bankers claim that the probability that the mispricing of risks in derivatives could lead to a systemic shock is low . . . ."); *The Beauty in the Beast*, *supra* note 2, at 24 ("[B]ecause derivatives contracts are a way of spreading the risk, they should improve rather than damage the aggregate position of companies linked by them.").

230. Plender, *supra* note 229, at 17. Market risk defines "the prospect that prices will take off in a direction that leaves them [dealers] losers on unhedged positions." Loomis, *supra* note 195, at 52; *see* Hu, *supra* note 192, at 1468-69 (discussing market risk for seller of option as risk that underlying asset will move in wrong direction, and noting that losses are potentially unlimited). When a bank loans money to a corporation, market risk arises because interest rates or other market factors may move in an adverse position. *Id.* In contrast to the risk of unlimited losses from derivatives contracts, the maximum loss from a bank loan is usually the "sum of the principal and the accrued interest." *Id.*

231. *See* Plender, *supra* note 229, at 17. "Counterparty credit risk" involves the threat of default by the opposing party to a derivatives contract. *Id.*; Hu, *supra* note 192, at 1468-69 (discussing credit risk as buyer worrying whether seller of an option, or "writer," will fail to perform). A bank assumes credit risk when it loans money, the risk

Fourth, because a financial instrument cannot be replaced at close to its fundamental value, derivatives hold out the chance of liquidity risk.[232] Fifth, the potential failure of internal control systems, including computers, gives rise to operational risk.[233] Lastly, the significant losses at major institutions in recent months may have stemmed from legal risk,[234] where one of the parties was unauthorized to conduct such business, and the derivatives contract thus may be unenforceable.[235]

Apart from obstacles to the users of derivatives, derivatives activities cause financial risks associated with the disclosure prac-

---

being that the borrower will fail to perform its obligations. Hu, *supra* note 192, at 1468-69. Because of counterparty credit risk, opposing parties to the contract could ask, for the duration of a deal that may take years, "will the guy on the other side of the contract be good for whatever he turns out to owe, if anything?" Loomis, *supra* note 195, at 44. Although dealers investigate the credit quality of their counterparties, a five- or ten-year derivative contract may cause a counterparty's creditworthiness to deteriorate. *Id.* at 52.

232. Plender, *supra* note 229, at 17. This is also known as valuation risk. Loomis, *supra* note 195, at 53. Volatility is measured based upon the expectations, rather than the true value, of the contracting parties. *Id.* Thus, valuation risk "addresses the possibility that the profits of a transaction may be misstated." *Id.*

This idea is best understood by analyzing the theory behind investment in the stock or bond markets, and the concomitant theory of true value. BERNSTEIN, *supra* note 40, at 7. The prices of stocks and bonds move in response to information of all types. *Id.* Furthermore, the prices of stocks and bonds are liquid, enabling purchases and sales to be easily reversed. *Id.* Lastly, stock and bond prices "reflect people's hopes and fears about the future, which means they can easily wander away from the realities of the present." *Id.* at 8. Economists, therefore, note that "value refers to something that lies behind, or beneath, the prices observed in the marketplace." *Id.* at 117. "Prices gyrate around 'true value.' " *Id.* The liquidity risk stems from the basic uncertainty in the underlying asset; in the case of a stock or bond, that asset's price is subject to the expectations of random investors in the market place, rather than the true value of the asset. *Id.* Indicating the uncertain nature of true value, Bernstein analogizes it to an exchange among three baseball umpires trying to describe how they call balls and strikes: " 'I call them as I see them,' said the first. 'I call them as they are,' replied the second. 'They ain't nothing till I call them,' declared the third." *Id.*

233. Plender, *supra* note 229, at 17.

234. GAO REPORT, *supra* note 192, at 64-65. Legal risk in a derivatives contract exists because of the possibility that a court or regulatory body may find the contract unenforceable. *Id.* at 64. For example, losses suffered by Orange County, California implicated legal risk. *See* Laura Jereski, *Orange County Seeks Fast Ruling that Merrill Deals Weren't Legal*, WALL ST. J., Feb. 1, 1995, at B7 (discussing Orange County's claim that transactions called reverse-repurchase agreements, executed by Merrill Lynch for county, violated California constitutional limitation on municipal debt, were beyond scope of municipality's power, and thus would enable county to rescind deal with Merrill Lynch); G. Bruce Knecht, *P&G Amends Lawsuit Naming Bankers Trust*, WALL ST. J., Feb. 7, 1995, at A3 (reporting Proctor & Gamble's new claim that Bankers Trust violated U.S. federal securities laws in sale of swaps based on German interest rate after SEC announced that similar derivatives transactions fell within ambit of securities laws).

235. Plender, *supra* note 229, at 17.

tices by corporations and financial institutions.[236] Derivatives are termed off-balance-sheet[237] instruments[238] because accounting rules[239] do not require that their rapidly-changing values be reported on the balance sheet.[240] In order to improve financial reporting and accurately state the changing values of derivatives, banks have adopted the practice of marking to market.[241]

---

236. *Id.*

237. *See* SCOTT, *supra* note 1, at 24. A "balance sheet" is the financial statement of a business or institution that compiles and lists the assets, liabilities, and owners' investment on a specified date. *Id.* "Off-balance-sheet activities" involve commitments of banks that do not appear on their balance sheets but, nevertheless, represent contractual obligations. WOELFEL, *supra* note 95, at 866.

238. Loomis, *supra* note 195, at 41. The problems associated with an "off balance-sheet" instrument were demonstrated with the losses suffered by a Japanese oil company. Plender, *supra* note 229, at 17. In the early part of 1994, Kashima Oil learned that it had lost US$1.5 billion in foreign exchange derivative trading (the underlying asset was an exchange rate of a foreign country). *Id.* The creditors of the company might have believed they were dealing with a company that was only subject to fluctuations in oil prices. *Id.* However, the company was also a foreign exchange dealer, not represented on the balance sheet, which created currency risks that soon caused the heavy losses. *Id.*

239. *See* GAO REPORT, *supra* note 192, at 92. Accounting rules provide investors, creditors, regulators, and other users of financial reports with consistent and reliable information by ensuring accurate financial reporting. *Id.* In the United States, "[a]ccounting rules define how the transactions of an enterprise should be recognized, measured, and reported in the enterprise's financial statements." *Id.* at 93.

240. Plender, *supra* note 229, at 17. A bank may borrow in such a way that the obligation is not recorded on its financial statement. WOELFEL, *supra* note 95, at 866. Financial futures and options contracts are obligations that need not be recorded on a bank's balance sheet. *Id.* Although such activities may increase a bank's exposure to risk, the off-balance-sheet activities offer more leverage than would be obtained from the bank's lending and investment activities. *Id.* Accounting rules established by the Financial Accounting Standards Board ("FASB"), called Statements of Financial Accounting Standards ("SFAS"), only address forward contracts and futures contracts, with no specific rules regarding swaps or options. *See* BILL D. JARNAGIN & JON A. BOOKER, *SFAS No. 52 (December 1981), Foreign Currency Translation, in* FINANCIAL ACCOUNTING STANDARDS 987, 1000-01 (1985) [hereinafter *SFAS No. 52*] (explaining that forward exchange contracts entered into for speculative purposes are recorded on balance sheet at market value, with subsequent changes in market value recorded as gains or losses on income statement); BILL D. JARNAGIN & JON A. BOOKER, *SFAS No. 80 (August 1984), Accounting for Futures Contracts, in* FINANCIAL ACCOUNTING STANDARDS 1045, 1045 [hereinafter *SFAS No. 80*] (explaining accounting treatment for exchange traded futures contracts in United States or other countries, and specifying that unless futures contract is used as hedge of an asset or liability carried on balance sheet at cost, any gain or loss in market value is immediately recognizable on financial statement). Because there are no rules for options, swaps, or forwards not involving foreign exchange rates, such contracts are reported, in practice, by analogy to *SFAS No. 52* and *SFAS No. 80*. GAO REPORT, *supra* note 192, at 95-96.

241. *See* DOWNES & GOODMAN, *supra* note 46, at 248. The term "mark to the mar-

II. *REGULATORY APPROACHES TO DERIVATIVES IN THE UNITED STATES AND JAPAN*

The U.S. financial futures markets, which began trading in 1974,[242] benefit from over twenty years of experience as compared with ten years for the Japanese futures markets.[243] Notwithstanding this experience, large losses registered by such entities as MG Corp.,[244] Showa Shell Co.,[245] Gibson Greetings Co.,[246] Orange County,[247] and Barings PLC[248] between 1992 and early 1995 have caused the U.S. Congress[249] and U.S. regulatory

---

ket" denotes adjustment of the value of a security to reflect current market values. *Id.*; Plender, *supra* note 229, at 17.

242. *See supra* note 5 (explaining beginning of U.S. futures trading on exchanges with establishment of CFTC). Under the Act, the CFTC assumed broad powers, including the right to close markets and fix prices. John H. Stassen, *The Commodity Exchange Act in Perspective: A Short and Not-So-Reverent History of Futures Trading Legislation in the United States*, 39 WASH. & LEE L. REV. 825, 833 (1982).

243. Semkow, *supra* note 180, at 29. The MOF created the derivative financial products markets on October 19, 1985 by establishing a futures market for Japanese government bonds on the TSE. *Id.*; *see supra* note 3 (noting same).

244. Reerink, *supra* note 2, at 58. The oil trading firm MG Corp, the U.S. subsidiary of Metallgesellschaft AG, a metals and mining conglomerate in Frankfurt, Germany, reported losses of US$1.3 billion in November 1993. *Id.* MG Corp. hedged its long-term supply agreements with futures contracts on the New York Mercantile Exchange. *Id.* MG Corp. bet that oil prices would rise, and lost when oil markets dropped six percent. *Id.*

245. *Id.* at 62. Showa Shell Co. is a Japanese oil refining company, 50% of which is owned by Royal/Dutch Shell Co. *Id.* In 1992, Showa Shell Co. currency traders lost US$1 billion from misplaced bets that the yen would fall against the dollar. *Id.*

246. Lipin & Taylor, *supra* note 2, at C1. Gibson Greetings Co. sued Bankers Trust, a leading derivatives dealer, for losses suffered from derivatives that Bankers Trust advised for purchase. *Id.* The SEC and CFTC secured a consent decree from Bankers Trust, in which Bankers Trust settled charges that it wilfully misled Gibson Greetings in the OTC swaps market. *Id.*

247. Knecht, *supra* note 2, at A3. Orange County, California suffered over US$1.5 billion in losses from a devaluation in its investment portfolio, managed by Robert Citron, the fund's manager and county treasurer. *Id.* Using funds managed for a large number of California municipalities and public agencies, the treasurer leveraged US$7.5 billion by investing in derivatives. *Id.* The derivative investments accounted for 42.5% of the fund's investments before the losses. *Id.* Rising interest rates caused the county's portfolio to fall in value because the treasurer had bet rates would fall. *Id.*

248. Webb, *supra* note 2, at A1. Barings PLC, a two-century-old British investment bank, collapsed when Nicholas William Leeson, one of the firm's traders in Singapore, lost over US$1 billion from huge volumes of futures and options trading in Japanese stock-index futures contracts. *Id.*

249. *See* 141 CONG. REC. E447-01 (daily ed. Feb. 27, 1995) (statement of Rep. Edward J. Markey [D-Mass.]) (proposing Derivatives Dealers Act of 1995 in response to "disastrous consequences of derivatives losses by Barings PLC—one of Great Britain's oldest merchant banks"); 141 CONG. REC. E35-02 (daily ed. Jan. 5, 1995) (statement of Rep. Henry B. Gonzalez [D-Texas]) (proposing Derivatives Safety and Soundness Su-

agencies[250] to question the regulatory structure of the derivatives markets.[251] Although Japan's tightly regulated derivatives markets differ from U.S. derivatives markets, Japan has promulgated new regulations such as increased disclosure requirements for financial institutions.[252] Increased regulations in the Japanese derivatives markets have caused Japanese investment capital to flee to overseas markets.[253]

A. *Present Regulations in the United States*

The establishment of the Commodity Exchange Act[254] ("CEA") in 1936 created the legal structure for U.S. futures trading in goods other than grain.[255] The 1974 amendments to the CEA reserved power to the Commodity Futures Trading Commission[256] ("CFTC") and expanded the definition of a commodity[257] to include any future that could be traded in the markets.[258] Because of the SEC's responsibility for securities-related

---

pervision Act of 1995 after Orange County went bankrupt from derivatives holdings); *see also supra* notes 247-49 (discussing losses by Orange County and Barings PLC).

250. *Compare supra* note 246 (indicating that SEC and CFTC used securities laws for first time in attempt to control derivatives trading in Bankers Trust case with Gibson Greetings Co.) *with Feuding Away Their Futures*, ECONOMIST, Oct. 15, 1994, at 101 (noting that Chicago's two largest futures exchanges, Chicago Board of Trade and Chicago Mercantile Exchange, sought less regulatory intrusion from CFTC in bid to attract more investment in risk-management products).

251. *See supra* notes 244-50 and accompanying text (explaining losses in major institutions and noting congressional response).

252. *See Japan to Stiffen Derivatives Audits, Disclosure for Banks, Securities Firms*, *supra* note 4 (reporting that MOF will increase audit staff and demand tighter disclosure requirements from financial institutions trading in OTC derivatives).

253. *See Regulations on Derivatives Market Called Premature*, Japan Econ. Newswire, Oct. 14, 1994, *available in* LEXIS, News Library, JEN File (noting that regulations cause derivatives dealers, including securities firms and banks, to move offshore).

254. 7 U.S.C. §§ 1-26 (1988 & Supp. V 1993).

255. *See* 7 U.S.C. § 2a(ii) ("This chapter shall apply to . . . contracts of sale (or options on such contracts) for future delivery of a group or index of securities . . . .").

256. 7 U.S.C. § 2(a)(2); *see supra* note 5 (explaining Commodity Futures Trading Commission Act, which first established CFTC); Jerry W. Markham, *The Commodity Exchange Monopoly—Reform Is Needed*, 48 WASH. & LEE L. REV. 977, 984 (1991) (explaining same). The Commodity Exchange Act ("CEA") provides that all transactions in commodity futures contracts and commodity options, with certain exceptions, must occur on or subject to the rules of the futures exchanges, which are subject to the supervision of the CFTC. 7 U.S.C. § 2a(ii); Cunningham, *supra* note 187, at 164.

257. 7 U.S.C. § 1a(3) (1988 & Supp. V 1993). "Commodity" includes certain enumerated agricultural products and "all other goods and articles, except onions . . . and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in." *Id.*

258. *Id.*; Cunningham, *supra* note 187, at 164.

products and the CFTC's supervision of futures exchanges, the SEC and CFTC share regulatory oversight of derivative products.[259]

1. Regulatory Responsibilities for the SEC and CFTC in the U.S. Derivatives Markets

The type of instrument and the entities involved in derivatives transactions determine the agency that regulates the contracts.[260] Exchange-traded derivatives, based on securities or options on securities are regulated by the SEC.[261] Derivatives contracts on commodities, including commodity futures,[262] commodity options,[263] and options on commodity futures,[264] executed on a commodities or futures exchange are regulated by the CFTC.[265] The CFTC possesses exclusive jurisdiction to regu-

---

259. Arbor, *supra* note 190, at 13N. The SEC supervises all trading in securities-based products. *See* Exchange Act, 15 U.S.C. § 78b (1988 & Supp. V 1993) (providing reasons for implementation of Exchange Act, including necessity to monitor and control securities transactions conducted on securities exchanges). "Security" is defined with reference to a list of non-exclusive items, and a caveat stating "in general, any instrument commonly known as a 'security.'" 15 U.S.C. § 78c. The SEC was established to oversee rules enumerated in the Exchange Act. 15 U.S.C. § 78d. The CFTC oversees derivatives based on products traded over designated futures exchanges, such as the Chicago Board of Trade. *See* 7 U.S.C. § 2 (granting jurisdiction to CFTC over "transactions involving contracts of sale of a commodity for future delivery, traded or executed on a contract market designated pursuant to . . . any other board of trade, exchange, or market").

260. Balvinder S. Sangha, *Financial Derivatives: Applications and Policy Issues*, BUS. ECON., Jan. 1995, at 46.

261. 15 U.S.C. § 78c; *see supra* note 259 (defining security under Exchange Act and noting SEC supervision of securities transactions over exchanges). The Securities Act also defines security, encompassing within the definition any right or contract to purchase a security, otherwise known as a stock option. 15 U.S.C. § 77b(1) (1988 & Supp. V 1993). Generally, the SEC has jurisdiction over all instruments that fall within the definition of a security, and that are not exempt under Section 3(a)(2)-3(a)(8) of the Securities Act or Section 3(a)(12) of the Exchange Act. 15 U.S.C. § 77c; 15 U.S.C. § 78c(a)(12).

262. *See* WOELFEL, *supra* note 95, at 503. A commodity futures contract obligates the seller to deliver a standard quantity of specific commodity on a specific future date. *Id.*; *see supra* note 3 (defining futures); *supra* note 257 (noting definition of "commodity" in CEA).

263. *See* Cunningham, *supra* note 187, at 128. A commodity option involves the right, but not the obligation, to purchase or sell a specified quantity of a commodity at a specified price. *Id.* The option may be settled through physical delivery of the commodity, or with a cash payment. *Id.*

264. *See supra* notes 194, 262 (defining option and commodity futures, respectively).

265. Sangha, *supra* note 260, at 46. The Chicago Board of Trade is an example of

late trading in commodity contracts for future delivery, or futures contracts, and options thereon.[266]

Over the counter transactions are excluded from both the SEC's and the CFTC's jurisdictions.[267] The SEC/CFTC Jurisdictional Accord[268] divided all exchange traded and OTC derivatives between the SEC and CFTC and defined the parameters under which each agency could regulate or exempt derivative products from its respective supervision.[269] On January 14, 1993, the CFTC adopted regulations exempting swap agreements, the most common OTC contracts,[270] from the CEA pursuant to an

---

a futures exchange regulated by the CFTC. Arbor, *supra* note 190, at 13N. The CFTC monitors the futures markets to ensure a competitive environment with transparent prices. *Id.*

266. 7 U.S.C. § 2a(ii); Russo, *supra* note 186, at 606. Futures trading in the United States is confined to CFTC-approved futures exchanges. *See* 7 U.S.C. § 2a(v) (forbidding trading of futures unless § 2a(ii) is satisfied, which limits futures trading to a board of trade approved by CFTC). Foreign currency futures have traded on the Chicago Mercantile Exchange since their introduction in 1972. Sangha, *supra* note 260, at 46. In 1973, the Chicago Board of Trade established the Chicago Board Options Exchange to execute transactions involving options on selected stocks. *Id.*

267. Russo, *supra* note 186, at 610-12. OTC derivatives are not viewed as securities, and thus derivatives dealers need not be registered as broker-dealers under the Exchange Act. Cunningham, *supra* note 187, at 162; *see* 15 U.S.C. § 78c(a)(4)-(5) (defining broker and dealer as person involved in effecting transactions in or buying and selling securities). The CFTC exempted OTC swap transactions from its control by virtue of the Futures Trading Practices Act of 1992 ("FTPA"). 7 U.S.C. § 6(c)(5) (1988 & Supp. V 1993); Cunningham, *supra* note 187, at 164. Also exempted from the CFTC's power are products that are not futures contracts or commodity options, products falling within the Treasury Amendment's exemption for foreign products, and forward contracts. *See* Russo, *supra* note 186, at 610-12 (describing these exclusions); 7 U.S.C. § 2 (1988 & Supp. V 1993) (exempting from CFTC certain transactions, such as those involving foreign currency, security warrants, security rights, and others designated by Treasury Amendment); 7 U.S.C. § 1a(11) (1988 & Supp. V 1993) (excluding contracts relating to sale of any cash commodity for deferred shipment or delivery).

268. 7 U.S.C. § 2a(i). The SEC/CFTC Jurisdictional Accord ("Accord") split jurisdiction between the SEC and CFTC over certain products. *See* 7 U.S.C. § 2a(i) (withdrawing from CFTC jurisdiction over options on securities or on index of securities).

269. *See* Russo, *supra* note 186, at 607-08. The Accord "split jurisdiction over options and futures contracts on certain financial instruments" between the two agencies. *Id.* Pursuant to the Accord, the CFTC has exclusive jurisdiction over all futures contracts, futures on stock indices, and options on futures and options on physical commodities. 7 U.S.C. § 2a(ii). The SEC, however, may veto stock index futures contracts that fail to meet specific statutory criteria. 7 U.S.C. § 2a(iv)(II). "Generally . . . foreign futures contracts are permitted to be offered and sold to U.S. persons, except for foreign stock index futures contracts . . . . [S]tock index futures transactions [are prohibited] in the United States, unless the CFTC finds that a specific contract meets certain criteria." Russo, *supra* note 186, at 608.

270. *See supra* note 221 (noting size of global swap market, variety of participants in swap market, and host of uses for swap products).

amendment to the CEA, enacted by Congress in 1992.[271] The Futures Trading Practices Act[272] ("FTPA") restricts the CFTC from conflicting with the SEC/CFTC Jurisdictional Accord.[273]

2. Recent Proposals for Regulations in U.S. Derivatives Markets

Several members of the U.S. Congress reacted to huge losses from derivatives by proposing additional regulations in the derivatives markets.[274] In response to recommendations for regulation from the General Accounting Office,[275] Senator Byron Dorgan (D-N.D.) submitted a proposal to regulate federally-insured banks engaged in derivatives trading.[276] Senator Richard G. Lugar (R-Ind.) authored a bill[277] to reauthorize the CFTC to

---

271. FTPA, 7 U.S.C. § 6(c)(5)(B) (1988 & Supp. V 1993). The FTPA enables the CFTC to exclude from regulation transactions containing characteristics of futures contracts. Cunningham, *supra* note 187, at 164. In particular, the amendment to § 6(c)(5)(B) empowers the CFTC to exempt swap agreements from CEA regulation. 7 U.S.C. § 6(c)(5)(B). The CFTC's exemption of swap agreements was a response to a negative reaction by participants in the swap market, who shifted swap transactions to overseas markets because of regulations of swaps prior to the FTPA's exemption. Cunningham, *supra* note 187, at 164.

272. 7 U.S.C. § 6(c)(5)(B) (1988 & Supp. V 1993).

273. *Id.* § 2(a)(i). The CFTC has exemption power, with certain exceptions. *Id.* § 6(c)(1). One exception forbids the CFTC from conflicting with any of the purposes of the CEA. *Id.* § 6(c)(2)(A). Thus, the CFTC cannot exempt from its regulatory power products over which it does not possess jurisdiction, as indicated in the Accord. *Id.* § 2a(i).

274. *See supra* notes 244-50 (noting losses by financial institutions such as Barings PLC and Orange County, which sparked congressional proposals for reform in U.S. derivatives markets).

275. *See* GAO REPORT, *supra* note 192, at 9. The report recommends that financial institutions should set aside extra capital against their exposure to derivatives dealing, and such institutions should report to a special regulator. *Id.*

276. 140 CONG. REC. S5247-02 (1994). In a separate writing, Sen. Byron Dorgan (D-N.D.) noted that the General Accounting Office found that OTC dealing was concentrated among 15 major U.S. dealers, including federally insured banks. Byron Dorgan, *Very Risky Business*, WASH. MONTHLY, Oct. 1994, at 36, 38; GAO REPORT, *supra* note 192, at 9. Senator Dorgan suggested that he introduced the bill in the U.S. Senate to "prohibit banks and other federally insured institutions from playing roulette in the derivatives market." Dorgan, *supra*, at 40. Presently, bank capital adequacy requirements regulate OTC derivatives transactions by banks. Cunningham, *supra* note 187, at 154. The Federal Deposit Insurance Corp. and the Office of the Comptroller of the Currency have published capital guidelines to regulate national banks, and state banks that are not members of the Federal Reserve. *Id.* The Federal Reserve published its risk-based capital guidelines for state member banks and bank holding companies in January 1989. *Id.*

277. *See* 141 CONG. REC. S653-02 (1995) (reauthorizing CFTC in response to CFTC's exemption of OTC derivatives trading from its regulatory power under FTPA

exercise its regulatory oversight responsibilities and assert its control over OTC transactions through the year 2000.[278] In an attempt to apply regulations to unregulated dealers in the OTC markets, Representative Edward Markey (D-Mass.) proposed the Derivatives Dealers Act[279] in early 1995 following the Barings PLC debacle.[280] Representative Henry Gonzalez (D-Tex.) proposed legislation calling for greater disclosure of derivatives activities of all types of financial institutions.[281] In contrast to the House of Representatives, members of the Senate Banking Committee refused to embrace calls for new regulations over the derivatives markets.[282]

Although the CFTC was originally modeled on the SEC,[283] there are several differences in regulatory approaches between the two commissions.[284] These differences have caused academics to suggest unification of the regulatory bodies or creation of a supra-agency.[285] Furthermore, the CFTC initially has explored

---

and need for "confidence" in these new markets); *supra* notes 271 and accompanying text (describing purpose of FTPA, which grants authority to CFTC to exempt transactions from regulation, especially swap agreements).

278. *See* 7 U.S.C. § 16(d) (amending previous section 12(d) to authorize grant of necessary funds to CFTC for years 1995 through 2000).

279. *See* 141 CONG. REC. E447-01 (Feb. 27, 1995) (statement of Rep. Edward Markey [D-Mass.]) (introducing Derivatives Dealers Act of 1995 to improve supervision and regulation of dealers of derivatives in OTC market, including customer protections such as full disclosure, accurate financial accounting, supervised sales practices, and antifraud provisions).

280. *See supra* note 248 (explaining bankruptcy of Barings resulting from derivatives trading on Japanese stock index futures contracts). A dealer in Singapore singlehandedly caused over US$1 billion in losses for Barings. *Id.*; Nicholas Bray & Lawrence Ingrassia, *Losses at Barings Grow to US$1.24 Billion; British Authorities Begin Sale of Assets*, WALL ST. J., Feb. 28, 1995, at A3.

281. *See* 141 CONG. REC. E35-02 (Jan. 5, 1995) (statement of Rep. Gonzalez) (introducing Derivatives Safety and Soundness Supervision Act of 1995 and citing Orange County's losses as indicative of trouble caused by "risky investments" of derivatives).

282. Tim Carrington, *Few Support Any New Rules on Derivatives*, WALL ST. J., Jan. 6, 1995, at A3. In addition, heads of several U.S. regulatory bodies rejected new governmental regulations in response to financial disasters suffered by such institutions as Gibson Greetings Co. *See id.* (noting opposition from Federal Reserve Chairman Alan Greenspan, SEC Chairman Arthur Levitt, and CFTC Chairman Mary Schapiro); *supra* note 246 (discussing derivatives losses suffered by Gibson Greetings Co.).

283. Stassen, *supra* note 242, at 833.

284. *See* Jerry W. Markham & Rita McCloy Stephanz, *The Stock Market Crash of 1987—The United States Looks at New Recommendations*, 76 GEO. L. J. 1993, 2023-24 (1993) (explaining differences between SEC and CFTC, such as CFTC's encouragement of speculation in futures markets in contrast to SEC's maintenance of orderly market).

285. *See, e.g., id.* at 2027-31 (discussing developments toward unification but arguing vehemently against such prospect).

coordination of the regulatory systems that oversee derivatives, futures, and securities.[286] For example, the SEC and CFTC cooperated in obtaining a consent decree from Bankers Trust,[287] charging the bank with violating antifraud sections of federal securities laws.[288]

B. *Present Regulations in Japan*

Unlike the system in the United States, the Japanese regulatory structure combines the cash[289] and derivatives markets and allocates their supervision to the MOF.[290] Japanese regulatory officials assert that they do not want to make the same mistakes in their fledgling markets that other established markets, such as the United States, have made.[291] Japan's apprehension in the derivatives markets has led to excessive and burdensome regulations, leaving investors with no alternative but to invest in overseas financial markets.[292] The over-regulated derivatives markets

---

286. Camden R. Webb, Note, *Salomon Forex, Inc. v. Tauber—The "Sophisticated Trader" and Foreign Currency Derivatives Under the Commodity Exchange Act*, 19 N.C. J. INT'L. L. & COM. REG. 579, 605-06 n.190 (1994).

287. *See supra* note 246 (explaining SEC and CFTC settlement with Bankers Trust).

288. Lipin & Taylor, *supra* note 2, at C1. Bankers speculated that such coordination could set precedents for dealers who sell derivatives presently free from exchange regulations and SEC and CFTC jurisdictions. *Id.* "For instance, the swaps sold to Gibson Greetings are being treated as securities like bonds . . . . Swaps have traditionally been exempt from securities laws, but the agencies found 'embedded' securities within the swaps." *Id.* If securities laws apply to swaps, tougher antifraud rules will apply for the dealers, who will then be liable for untruths in sales tactics. *See* 15 U.S.C. § 78j; Rule 10b-5, 17 C.F.R. § 240.10b-5 (1994) (forbidding employment of manipulative and deceptive devices by those involved in transaction); 17 C.F.R. § 240.10b-3 (1994) (prohibiting employment of manipulative and deceptive devices by brokers or dealers).

289. Morinobu, *supra* note 169, at 215-16. The "cash market" involves trades for the immediate sale or purchase of a particular item. SCOTT, *supra* note 1, at 51. Also called the "spot market," the term distinguishes "transactions involving immediate or nearly immediate delivery from transactions requiring delivery at a future time." *Id.*

290. *See supra* note 129 (indicating MOF's power to approve new security instruments under Article 2 of SEL). Morinobu, *supra* note 169, at 215-16. In the United States, the CFTC regulates future transactions and commodity transactions, while the SEC regulates securities transactions involving immediate delivery. *See supra* notes 260-74 and accompanying text (describing same).

291. Yamashita, *supra* note 6, at 222; *see supra* notes 3-5 (discussing Japan's late beginnings in derivatives markets as compared with United States).

292. *See* Sieg, *supra* note 8 ("Participants in Tokyo financial markets have complained that excessive formal and informal regulations are dampening derivatives deals and forcing potentially lucrative business offshore."); *see Japan to Stiffen Derivatives Audits, Disclosure for Banks, Securities Firms*, *supra* note 4 (reporting that official of Bank of Tokyo argued that restrictive rules imposed by MOF will cause users to flee and market

in Japan are due, in part, to a deficient understanding of the positive attributes that derivatives contribute to a financial system.[293]

1. Regulatory Responsibilities in Japanese Derivatives Markets

Regulatory integration of the cash and derivatives markets was designed to encourage futures transactions,[294] but Japanese investors have generally shunned the futures and options markets.[295] One explanation for the diminished investor participation is that dealers have used the futures markets primarily for speculation, thereby increasing the risks inherent in any given transaction.[296] Additionally, the MOF's restrictive regulations imposed on derivatives such as stock index futures[297] has had a

---

will die, and that upcoming regulatory action has forced banks and securities companies to increase derivatives business in other countries).

293. *Japan Shows Gaps With Other Nations on Derivatives*, Japan Econ. Newswire, Oct. 20, 1994, *available in* LEXIS, News Library, JEN File (reporting that comments by managing director of the TSE, at recent Tokyo meeting, asking for more regulations to ensure orderly market contrasted with other speakers' remarks calling for flexible regulations to facilitate development of derivatives markets); *see supra* note 201 and accompanying text (describing that derivatives offer reduced transaction costs and better leveraging opportunities to investors).

294. Yamashita, *supra* note 6, at 215. This one market approach in Japan is similarly applied to Japanese derivative products traded in other countries. *Id.* at 221. Because derivatives based upon Japanese stock price indices are traded in overseas markets, TSE, as a cash market, concludes agreements with non-Japanese stock exchanges or futures exchanges where non-Japanese exchanges seek to trade Japanese index derivatives on their market. *Id.*

295. ISAACS, *supra* note 123, at 220. "Although futures hold enormous potential for the Japanese securities firms to hedge their equity positions and thus decrease their downside risk of acting as a principal in equity trades, it is questionable whether the hedging is actually being done." *Id.*

296. *Id.* at 221.

> [T]hey [dealers] have been using computer trading to spot 'arbitrage windows' in the market and simply pressing the button to trade at their dealing desks in a frenzy of trading greed, but with no stringent controls on the hedging effect that the futures trades will have on their open equity positions.

Id. Such a fear that arbitraging will destabilize the market is perhaps unfounded. *See* BERNSTEIN, *supra* note 40, at 171 ("Arbs have acquired a certain notoriety because they seem to be operating in some price-manipulative fashion. . . . Actually, they keep the markets honest. They bring perfection to imperfect markets . . . [and] bid away the discrepancies in market prices . . . ."); *supra* note 40 (discussing arbitragers' intentions in marketplace). In April 1990, TSE required arbitragers to publicly disclose their stock positions resulting from index arbitrage activities. Yamashita, *supra* note 6, at 219. This disclosure policy was enacted to aid investors in determining the amount of a stock position that remains to be liquidated in the market. *Id.*

297. *See* David Shireff, *Japan: MOF Clings to the Same Old Levers*, EUROMONEY, Feb. 1, 1994, at 32. The MOF has banned the writing of options on single stocks. *Id.*; SEL, Law

detrimental effect on participation, driving business to overseas exchanges.[298]

The restrictions in the Japanese financial markets generally derive from the MOF's authority to approve all newly offered security products on the exchanges, as mandated under the SEL.[299] In addition, although the MOF is authorized to grant licenses for investment in such financial derivatives as futures and options on interest rates and currencies,[300] it refuses to grant such licenses to speculators.[301] The SEL forbids options or futures written on single stocks, adding further restrictions to

---

No. 25 of 1948, art. 201 (Japan) (as amended to 1992) (Capital Markets Research Institute ed. & Toru Mori trans., 1993) (noting same). Japan's securities law, however, does allow options trading on other securities and on securities indexes. *See* SEL, Law No. 25 of 1948, art. 2.15 (Japan) (defining "securities options trading" as transactions giving holder of option right to buy or sell securities, as defined in Article 2, or futures on securities index).

298. Shireff, *supra* note 297, at 32. "Heavy margin requirements have been imposed on Nikkei 225 trading in Osaka, but that has simply driven the business to Simex, the Singapore futures exchange, where the Nikkei 225 is also traded." *Id.*; *see* George Melloan, *Leeson's Law: Too Much Leverage Can Wreck a Bank*, WALL ST. J., Mar. 6, 1995, at A15 (describing how careless trader made too many wrong bets on Nikkei 225 contracts trading on Simex exchange); *Hollowing out Japan's Financial Markets*, ECONOMIST, Aug. 13, 1994, at 67 (explaining that average daily business in Nikkei stock index futures on Simex, Singapore's derivatives exchange, is growing while such trading in Osaka, Japan is falling because it costs international investors 40% less to trade in Singapore than it does in Japan); *see also Back to the Futures: Japanese Derivatives*, *supra* note 4, at 82 (explaining MOF's desire to impose new controls on future industry, which MOF regards as "playground for naughty stockbrokers," by banning arbitrage trading, which accounts for 65% of total volume, in stock-index futures whenever MOF feels it is necessary).

299. *See* SEL, Law No. 25 of 1948, arts. 2, 107 (Japan). Article 2 lists eight types of "securities." *Id.* art. 2. Any other product not listed can become a security only if prescribed by the MOF. *Id.* art. 2.1(9). Firms intending to trade securities, as defined in Article 2, on a securities exchange must apply to become members of the exchange. *Id.* art. 107.

300. *See* FEL, Law No. 77 of 1988, art. 56 (Japan) (permitting persons to engage in "finanical futures brokerage business" only if licensed by MOF); *id.* art. 2.8 (defining "financial futures brokerage business" as acceptance of orders for "financial futures transactions"); Yamashita, *supra* note 6, at 229 (explaining that Tokyo International Financial Futures Exchange, established in 1989 after FEL was enacted, was first licensed futures and options exchange in Japan).

301. *Commodity Funds in Japan*, ECONOMIST, Oct. 8, 1994, at 87. Speculators include firms investing in commodity derivatives. *Id.* "By contrast, American commodity-trading advisers, as providers of such funds are known, nearly all take positions in financial as well as commodity derivatives." *Id.* In addition, brokerages wishing to expand their exchange business to currency swaps dealing and exchange options transactions were denied licensing by the MOF. Masato Kakihara, *Tokyo Report—Brokers' Discontent to Continue*, Jiji Press, Feb. 22, 1993, *available in* Westlaw, Int-News Database, JIJI File.

the derivative products available for trading in Japan.[302]

The Japanese financial structure additionally separates security derivative instruments from money market instruments.[303] Thus, the Securities Bureau of the MOF regulates the security derivatives market and the cash market in securities.[304] In addition, the Securities Bureau regulates all the derivative products of securities,[305] including bond futures,[306] options on bond futures, and stock index futures and options that are traded on the stock exchanges.[307] In contrast, money market instruments such as the yen-dollar exchange rate[308] and Euro-yen interest rate,[309] are traded on the Tokyo International Financial Futures Exchange.[310]

The MOF favors exchange-traded derivatives over OTC derivatives because the MOF can exercise more control over the securities traded, especially with its power to approve all new products.[311] Anti-gambling provisions in the SEL[312] and the

---

302. SEL, Law No. 25 of 1948, art. 201 (Japan); *see supra* note 297 (identifying same provision in SEL). *But see supra* note 253 and accompanying text (indicating U.S. policy to allow options and futures contracts on single stocks under Securities Act § 77(b)(1)).

303. Yamashita, *supra* note 6, at 216.

304. *Id.*

305. *See id.* at 218. The TSE and OSE divide responsibility for stock derivatives. *Id.* The TSE monitors underlying securities and the OSE caters mainly to index derivatives. *Id.*

306. Yamashita, *supra* note 6, at 216. A "bond" is a long-term promissory note. SCOTT, *supra* note 1, at 33. A "bond future" is an agreement to take (by the buyer) or make (by the seller) delivery of that bond on a particular date in the future. *See supra* note 3 (defining "futures contract").

307. Yamashita, *supra* note 6, at 216.

308. *See supra* note 17 (defining exchange rate). In terms of the dollar, the yen is worth a specified price, as defined by the prevailing exchange rate. *Id.*

309. Yamashita, *supra* note 6, at 216. "Euroyen" are yen deposits and yen currency that are held in countries other than Japan. VINER, *supra* note 11, at 330.

310. Yamashita, *supra* note 6, at 216. Stock exchanges may launch futures and options contracts as long as they are derived from securities. *See* SEL, Law No. 25 of 1948, art. 83 (Japan) (permitting stock exchanges to trade securities, as defined in Article 2, including "securities index futures trading and securities options trading"). Financial futures exchanges established under the FEL can introduce futures and options on underlying assets that are not explicitly defined in the SEL (i.e., that are not defined as securities). *See* FEL, Law No. 77 of 1988, art. 1 (Japan) (restricting coverage of FEL to "finanical futures transaction"); *id.* art. 2.4 (defining "financial futures transactions" as applying to futures and options on currencies and financial indexes).

311. *Japan Not Planning Tighter Equity Derivative Rules*, Reuters, Feb. 28, 1995, *available in* Westlaw, Int-News Database, REUTERNEWS File. Currently, the MOF is seeking to replace the Nikkei 225 index for exchange-traded derivatives with a new index, the Nikkei 300. *Id.*; *see supra* note 299 (explaining MOF's authority to approve new security

Commodity Exchange Law,[313] in addition to a narrow definition of securities in the SEL,[314] prevent dealers from creating new financial products.[315] All new financial products must first be approved by the MOF,[316] and then traded on an exchange, in order to satisfy Japanese regulations.[317] Swap transactions are not regulated by any formal laws or administrative guidances.[318] In order to control OTC trading in swap transactions, however, the MOF has required stricter disclosure rules by financial institutions dealing in such derivatives.[319]

2. Effect of MOF Regulations on Japanese Derivatives Markets

The MOF's tight control over the derivatives markets has caused Japanese investment firms to divert capital to overseas markets.[320] Fearful of the disasters suffered by more exper-

---

products before they are introduced on stock exchanges); FEL, Law No. 77 of 1988, art. 2.4(2) (Japan) (permitting transactions based on underlying values of financial indexes).

312. *See* SEL, Law No. 25 of 1948, art. 20 (Japan). Speculation on the securities index off the exchanges is prohibited. *Id.*

313. *See* Commodity Exchange Law of Japan, Law No. 239 of 1950, art. 145 (Japan), *translated in* 6 Law Bull. Series (EHS), MM1, MM97 (1986) (forbidding transactions based on quotations from commodity market unless executed on commodity exchange).

314. *See supra* note 299 (explaining definition of securities in SEL); Oda, *supra* note 133, at 142 (noting definition of securities in Japanese SEL focuses on legal form of products and is limited to regulation over traditional securities whereas Exchange Act in United States defines securities on a broader scale); *supra* note 259 (discussing Exchange Act's definition of securities in United States). New financial products usually fall outside of the Japanese SEL, and thus MOF approval is required in order to comply with the SEL. *Id.*

315. YASUDA ET AL., GLOBAL DERIVATIVES STUDY GROUP, DERIVATIVES: PRACTICES AND PRINCIPLES 217 (App. II: Legal Enforceability, July 1993).

316. SEL, Law No. 25 of 1948, art. 2.1(9) (Japan); *see supra* note 299 (noting need for MOF approval of all new security instruments).

317. SEL, Law No. 25 of 1948, art. 20 (Japan); *supra* note 299 (noting SEL's prohibition of off-exchange trading by members of exchange).

318. YASUDA, *supra* note 315, at 217.

319. *Japan to Stiffen Derivatives Audits, Disclosure for Banks, Securities Firms, supra* note 4. "The [MOF] will urge commercial banks to disclose sums of potential risks of over-the-counter instruments, including currency and interest-rate swaps, options . . . and exotic products." *Id.* The MOF will require banks to report to customers the reasons why derivatives are used and bank risk management policies followed in derivatives-related investments. *Id.*; *see Economic Developments and International Finance*, Banking Report (BNA) (Feb. 13, 1995) (noting MOF will reinforce regulations on financial derivatives sold by banks and securities firms).

320. *See Regulations on Derivatives Market Called Premature, supra* note 253 (noting that Japanese securities firms and banks have set up subsidiary companies in Singapore

ienced U.S. derivatives markets,[321] the MOF has responded with increased regulations,[322] forcing organizations such as the Global Derivatives Study Group[323] to claim that Japan lacks full understanding of the proper regulatory structure.[324] Furthermore, strict MOF regulations have strangled the growth of the Japanese derivatives markets by constricting dealers' participation in OTC transactions and forcing dealers and investors to trade only on heavily regulated exchanges.[325]

III. *JAPAN SHOULD HALT ITS REGULATION OF FINANCIAL DERIVATIVES MARKETS*

The U.S pressure for reform of the Japanese financial system in the 1980's, which triggered an overhaul of Japan's SEL, illustrated the close relationship between Japanese and U.S. fi-

---

and Hong Kong where derivative transactions are growing amid looser regulatory structures); Linda Sieg, *Japan Derivatives Players Bemoan Restrictions*, Reuters, Oct. 14, 1994, *available in* LEXIS, News Library, REUAPB File (reporting that heavy restrictions in Japanese markets force dealers to resort to "back-door deals" in OTC derivatives in overseas markets).

321. *See supra* note 6 and accompanying text (explaining Japanese determination to avoid perils suffered by "early starters" such as United States in derivative markets).

322. *See supra* notes 319 and accompanying text (analyzing Japanese regulations of derivatives).

323. *See* GLOBAL DERIVATIVES STUDY GROUP, DERIVATIVES: PRACTICES AND PRINCIPLES 3 (1993) [hereinafter GLOBAL DERIVATIVES GROUP]. The Global Derivatives Group offered 20 recommendations to dealers and end users of derivatives for better management of the risks associated with derivatives. *Id.* The Group of Thirty sponsored the study as an "unofficial but authoritative review of industry practices and performance." *Id.* at i.

324. YASUDA, *supra* note 315, at 218 (noting that "it is almost impossible to state definitively what the current regulatory position of the [Japanese] government is with respect to . . . swap transactions"). The study noted that by July 1993, no governmental agency had outlined clear guidance for regulation of swap transactions. *Id.*; *see* Shireff, *supra* note 297, at 32 (claiming that such actions as ban on sale of options on single stocks and arbitrary definition of financial instruments such as swaps result in "guiding market practice without writing clear rules" that cause obstacles to "efficiency and proper price formation").

325. *Japan a 'Developing Country' in Derivatives: Think Tank*, *supra* note 6 ("For further development, it is necessary for deregulation and efficiency of the transaction system to proceed."). The study also indicates that the Japanese total of investment in derivatives represents only 10.6% of the global total, estimated at US$35.1 trillion. *Id.* In addition, the study illustrates that Japanese derivative trading is concentrated in derivative products traded over securities exchanges, such as stock index futures or interest rate futures. *Id.* This compares unfavorably with U.S. and European derivative trading, which is predominantly over the counter, such as interest rate or currency swaps executed between investors. *Id.*

nance.[326] The two countries' elite statures within the global economy[327] present an ideal situation for information-sharing and influence-peddling for change in each other's financial markets. Despite this parallel situation between the United States and Japan, the United States has focused on conforming to the new global economy while Japan's MOF has resisted.[328] As global capital and resources increasingly flow toward emerging markets,[329] investors search for loosely regulated derivatives markets.[330] Favoring tighter regulations in the financial sector[331] and displaying an historical tendency to follow the United States in the financial markets,[332] Japan will likely pursue the U.S. course toward increased regulations of derivatives markets. Ja-

---

326. *See supra* notes 109, 124-30 and accompanying text (indicating U.S. pressure for reform of Japanese financial markets in early 1980's, which resulted in structural reform of Article 65 of SEL and introduction of Financial Systems Reform Law of 1992, permitting banks and securities firms to cross barrier previously separating them, and reserving right of MOF to approve all new securitized products not specifically deemed securities by SEL); *supra* note 292 (noting definition of "securities" in SEL).

327. *See* BILL ORR, THE GLOBAL ECONOMY IN THE 90S: A USER'S GUIDE 27 (1992). "The three economic superpowers," the United States, the European Community, and Japan "produced 57% of the gross world product with 13% of the world's population." *Id.* The "average per-capita GNP in these economies" exceeded the world average by four times in 1989. *Id.* Per capita GNP measures average output available for each person in a country's economy. *Id.* In 1989, Japan's economy outgrew all others, with a rate of 4.8%, compared to U.S. growth of three percent. *Id.* at 28.

328. Michael Hirsh, *Why Japan Won't Change*, INSTITUTIONAL INVESTOR, Sept. 1994, at 37-38. The powerful bureaucracy has been slow to institute deregulation in the markets. *Id.* at 37. The MOF has failed to respond to the "hollowing out" of the Japanese economy, or the movement of Japanese industry and services overseas. *Id.* at 38.

329. *See id.* at 38 ("Japan's financial markets have slowed as if hit by a sudden power drain. The electricity has flowed to the rest of Asia as resources and talent pour into a slew of emerging capital markets."); *Hollowing Out Japan's Financial Markets*, *supra* note 298, at 67 (reporting fear by "Tokyo's moneymen" that "financial business is fleeing to Singapore, Hong Kong and London").

330. *Tokyo's Financial Hypochondria*, ECONOMIST, Aug. 13, 1994, at 16 (indicating concern by Japanese businessmen that Japan as an "international financial centre" could by overtaken by its rivals in Hong Kong and Singapore because of "stiff regulation" that has "strangled trading in options and other derivatives in Japan").

331. *See supra* notes 20-22 and accompanying text (discussing MOF's extensive control over securities regulation and its refusal to minimize regulations in order to promote free financial markets); *supra* notes 140-44 and accompanying text (explaining MOF's use of informal, rather than formal, administration of securities laws and banking and insurance industries, in comparison to SEC's formal enforcement strategy in United States, but noting that public defers to MOF in all circumstances).

332. *See supra* notes 60-64 and accompanying text (discussing Occupation's successes in dissolving *zaibatsu* and democratizing Japan by shifting more power over economy to individual investors); *supra* notes 70-73 and accompanying text (explaining adoption of JSEC and SEL of 1948 in order to better replicate U.S. financial regulatory

pan, instead, should rebuke this tendency to follow the United States and welcome the benefits of a deregulated economy.[333]

A. *Why Japan Will Follow Present U.S. Solutions to Recent Problems Associated with Derivatives Trading*

The relationship between the United States and Japan indicates a history of strong U.S. involvement in the Japanese financial system. For example, when Japan was hurrying to catch up with the economies of the West during the post-World War II period,[334] Japan looked to the United States for guidance to establish a regulatory structure.[335] The Occupation, of which the United States was a prominent member,[336] restructured Japan during the post-World War II period under three democratization principles.[337] During the democratization process, the Occupation decentralized the financial system by dissolving the powerful *zaibatsu* and transferring the capital in the economy to individual investors.[338] The Occupation imposed the fundamental regulatory structure that still exists in Japan today, including the laws that govern Japan's financial system.[339]

Japanese securities regulation developed into a legal struc-

---

structure in Japan); *supra* note 91 (stating similarity between Article 65 of SEL of Japan to U.S. Glass-Steagall Act in its separation of banking and securities industries).

333. *See supra* note 7 (explaining that deregulation improves financial strength of nations because it reduces transaction costs, attracts new capital to financial markets, and increases flexibility of market participants).

334. *See* YAMASHITA, *supra* note 14, at 2 (explaining rapid rise of Japanese economy in three decades following end of World War II due, in part, to Western technology and low cost of energy).

335. *See supra* notes 60-76 and accompanying text (explaining three major changes to Japanese financial markets instituted by Occupation, including democratization by shifting power from *zaibatsu* to individuals, reorganization of banks within financial system, and creation of Securities and Exchange Law to manage and direct securities markets).

336. *See supra* notes 12-14 and accompanying text (discussing U.S. dominance of Occupation effort in Japan after World War II and resulting reform of Japanese financial system, which led to period of economic transformation until 1970's).

337. *See supra* notes 77-85 and accompanying text (listing Occupation's principles, including ban on futures trading and establishment of SEL of 1948 to satisfy Occupation's requirements as new guide for statutory regulation of Japanese securities markets).

338. *See supra* notes 60-64 and accompanying text (explaining dissolution of *zaibatsu* and increased power of individual investors within Japanese economy during post-World War II Occupation period).

339. *See supra* note 12 and accompanying text (asserting Occupation's role in reshaping Japanese financial system following World War II).

ture resembling that existing in the United States. The central aspect of the Japanese financial system, the SEL, was modelled on the U.S. securities acts.[340] In addition, Japan followed the U.S. Glass-Steagall Act[341] in erecting a wall between the securities and banking sectors of the economy.[342] The recent relaxation of Japan's Article 65 of the SEL as it applies to banks and securities firms resembles the current movement in the United States to dismantle the Glass-Steagall Act.[343] Finally, the MOF was given the same regulatory powers as the SEC in the United States.[344]

Given the U.S. experience with derivatives markets, having permitted exchange-traded derivatives since 1974,[345] Japan is again likely to seek guidance in its nascent derivatives markets.[346] Japan lacks a comprehensive understanding of derivatives, having recently introduced derivatives to the financial system.[347] In contrast, the United States began trading derivatives over its exchanges more than a decade prior to derivatives trading in Japan.[348] Consequently, Japan can benefit by studying U.S. mis-

340. *See supra* notes 86-91 and accompanying text (discussing parallel to U.S. Securities Act of 1933 and Exchange Act of 1934 and giving overview of securities regulations embodied in SEL of 1948).

341. *See supra* notes 91, 119 (discussing division between securities and banking in United States imposed by Glass-Steagall Act of 1933).

342. *See supra* notes 112-19 and accompanying text (explaining Articles 65 and 43 of Japanese SEL and Article 10 of Banking Law, which imposed same barriers between securities and banking as that created under Glass-Steagall Act in United States).

343. *See supra* note 123 and accompanying text (comparing recent liberalization of Japan's Article 65, separating banking from securities operations, with U.S. movement to repeal Glass-Steagall Act, providing same barrier in U.S. markets).

344. *See supra* note 87 (noting MOF as counterpart of SEC in United States).

345. *See supra* note 5 and accompanying text (signalling advent of exchange-trading in U.S. derivative markets with establishment of CFTC under 1974 amendments to CEA).

346. *See supra* notes 242-44 and accompanying text (explaining U.S. experience of 20 years in derivative markets in contrast to Japanese experience, which amounts to less than decade); *supra* note 6 and accompanying text (reporting Japan's determination to avoid mishaps suffered from derivatives by learning from mistakes made in more established derivatives markets, such as United States).

347. *See supra* notes 3-5 and accompanying text (comparing start of futures trading in Japan in October 1985 with exchange trading in United States in 1974); *supra* notes 179-87 and accompanying text (noting same but also indicating that futures and options markets were not subject to legal structure until 1988 in Japan, when SEL was revised and FEL was adopted, followed by introduction of TOPIX and Nikkei 225 to signal advent of equity derivative markets); KHOURY, *supra* note 8, at 116 ("The futures markets in Japan are still in their infancy in terms of diversity of products when compared with those in the United States.").

348. *See supra* note 5 and accompanying text (signalling opening of futures trading in United States with amendment to CEA creating CFTC to supervise all exchange-

takes.

The huge losses that have sparked congressional action in the United States, however, have contributed to Japan's fear of the effects of derivatives.[349] The MOF's fear of losses of such magnitude as Barings PLC has made the MOF hesitant to proceed without more regulations.[350] Several members of the U.S. Congress have introduced tighter regulations over OTC markets[351] and increased disclosure requirements for financial institutions conducting derivatives transactions over the exchanges.[352] The tendency is for the MOF to follow suit rather than risk financial losses and be accountable to a populace that can easily blame it for inaction.[353]

Japan should balance its desire to maintain a healthy economy against the need to curb the increasing flight of capital to non-Japanese financial markets because of existing regulations

---

traded futures activity); *supra* notes 254-60 and accompanying text (noting same and explaining that SEC and CFTC share regulatory responsibilities in U.S. derivatives markets, depending upon type of derivative product involved in transaction).

349. *See supra* notes 244-50 and accompanying text (discussing losses by major institutions such as MG Corp., Orange county, and Barings PLC that sparked proposals by some members of U.S. Congress to increase regulations of U.S. derivatives markets); *supra* notes 276-82 and accompanying text (specifying proposals by Sen. Dorgan, Rep. Lugar, Rep. Markey, and Rep. Gonzalez in United States that include greater regulations surrounding institutions that deal in derivative products); *see also* Linda Sieg, *Japan Derivatives Allergy Seen Boosted by Barings*, Reuters, Feb. 27, 1995, *available in*, Westlaw, Int-News Database, REUTERNEWS File. The article reports that Japanese regulators will likely increase regulatory measures in response to Barings PLC derivatives-related financial collapse. *Id.*; *see supra* note 248 (discussing collapse of Barings PLC in early 1995). Although the Barings case involved losses from exchange-traded derivatives as opposed to the more complex OTC instruments, Japanese regulators have harbored the same concerns with respect to futures, options and other exchange-traded instruments as they do with OTC derivatives. Sieg, *supra*.

350. *See* Sieg, *supra* note 349 (noting Japanese authorities' negative reaction to derivatives as result of Barings PLC's collapse).

351. *See supra* notes 276-81 and accompanying text (explaining proposals by Senator Dorgan and Rep. Markey to apply stricter regulations to dealers and federally insured banks in OTC derivatives markets and indicating bill passed to reauthorize CFTC control over OTC transactions through year 2000, originally proposed by Senator Lugar).

352. *See supra* note 281 and accompanying text (referring to Rep. Gonzalez's proposal for tighter disclosure standards with respect to derivatives transactions executed by all financial institutions).

353. *See, e.g.*, Hirsh, *supra* note 328, at 37 (explaining victory by Goldman Sachs, U.S. investment bank, in gaining approval by MOF to "launch Japan's first public issue of an asset-backed security" in 1994 after "haggling with the MOF for more than a year," which was concerned that "some unwitting Japanese investor might get burned and blame the ministry").

of Japanese derivatives markets.[354] Japan should determine whether following the United States will be more beneficial than pursuing deregulation of the derivatives markets.[355] Aside from an historical tendency to clone U.S. regulations in the financial markets, Japan's tightly regulated economy suggests partiality for restrictive policies such as those presently introduced in the U.S. Congress.

B. *Why Japan Should Not Follow the United States*

Japan should not implement more regulations in its derivatives markets, as are proposed in the U.S. markets, because Japan would substantially benefit from a more deregulated economy. Recent U.S. congressional proposals embrace more centralized regulations rather than focusing responsibility on institutions that incur derivatives-related losses.[356] Regulations would in-

---

354. *See supra* notes 320-23 and accompanying text (noting how MOF's response of increased regulations to mounting derivatives-related losses in world financial markets has sparked Japanese financial institutions to conduct derivatives trading in loosely regulated markets like Hong Kong and Singapore). Proponents of regulation for financial markets seek "to maintain stability in financial markets and to guarantee that vicissitudes in economic activity do not undermine the economic health of nations and of the world economy." Franklin R. Edwards, *Financial Institutions and Regulation in the 21st Century: After the Crash?, in* COMPETITION AND REGULATION IN FINANCIAL MARKETS 1, 1-2 (Albert Verheirstraeten ed., 1981).

355. *See* KHOURY, *supra* note 8, at 18. In general, financial market deregulation triggered development of innovative products during the 1970's, such as options and futures contracts. *Id.* "The explosion since then in these types of contracts, the instruments they cover, the uses they are put to . . . and other factors has been phenomenal." *Id.*; *see supra* notes 196-208 and accompanying text (explaining option-based and forward-based contracts as basic building blocks of all derivative instruments and noting their uses for individuals and dealers). Heavily regulated financial systems are no more stable than less regulated economies. KHOURY, *supra* note 8, at 37.

356. *See supra* notes 276-82 and accompanying text. The proposal by Senator Dorgan would create central regulations prohibiting federally insured banks from trading in derivatives. *Id.*; 140 CONG. REC. S5247-02 (1994). The Derivatives Safety and Soundness Supervision Act of 1995, authored by Rep. Gonzalez, would impose wholesale restrictions on derivatives trading by all types of financial institutions. 141 CONG. REC. E35-02 (daily ed. Jan. 4, 1995) (statement of Rep. Gonzalez). The bill would constrain derivatives dealers by imposing stricter disclosure standards in light of the losses suffered by Orange County, California. *Id.*; *supra* note 247 and accompanying text (explaining derivatives-related losses of California county). In contrast, an alternative view illustrates that derivatives threaten the financial condition of the entities using them. Douglas Kurz, *Watch Your Derivatives*, BUS. NEWS, Jan. 2, 1995, at 21. The appropriate response should involve improvement of risk management practices at such entities, an issue of internal control, rather than "some kind of generic regulation." *Id.* As other internal control systems, "controlling derivatives must take into consideration the company's culture, business objectives, financial condition and risk management practices."

crease the transaction costs of investing in derivatives.[357] This negates one of the advantages for using derivatives, which is to decrease costs of investment by either hedging other risky investments, or leveraging.[358]

Increased regulations will impede capital investment in Japan, as restrictions in the Japanese derivatives markets currently push participants to overseas markets.[359] In the alternative, should Japan not impose more restrictions, it would alert the securities firms in which the MOF intends to promote investment in Japan, and thus may induce the securities firms to stem their investments in emerging markets and return to Japan.[360] Furthermore, by not following the proposals in the United States for more regulation, Japan will gain an advantage over the United States. If more U.S. regulations increase costs, more capital will flee the U.S. derivatives markets in search of cheaper regulations

---

Id. Creating more centralized regulations socializes the risks. Jordan, *supra* note 345, at 1. Individuals "shed risk" by passing it to others, keeping unchanged the total risk for the system as whole because someone else bears risk. *Id.* The interplay of market forces more efficiently allocates the profits and losses from derivatives rather than centrally imposed regulations. *Id.* For example, exchanges hurt by the Barings PLC derivatives-related losses will probably increase their fees for trading on such exchanges. Martin Mayer, *How The Market Regulates Derivatives Risk*, WALL ST. J., Mar. 2, 1995, at A14. This is a "true free-market solution" because the exchanges and traders who were involved suffered the consequences by spending more to design "fail-safe systems to ensure that such a disaster won't happen again." *Id.*; *see supra* note 248 (explaining Barings disaster).

357. *See supra* note 7 and accompanying text (analyzing economics of deregulation as including reduction of transaction costs compared to economy with increased regulations in financial markets).

358. *See supra* notes 196-97 and accompanying text (describing advantage of derivatives as insulating other investments against losses and leveraging positions so as to create possibility of tremendous profits, sometimes reaching 40%). The private benefits of derivatives include lower transaction costs, which create an alternative to investing in the underlying asset, arbitrage opportunities between the price of the derivative and the underlying asset, and ability to control market risks such as interest rate and currency fluctuations. Hu, *supra* note 192, at 1465. Private benefits differ from social benefits, which focus on how derivatives "complete markets" by reducing transaction costs and agency costs. *Id.* at 1465 n.31.

359. *See supra* notes 320-26 and accompanying text (discussing Japan's minimal understanding of derivatives, which has resulted in more regulations, causing investors to flee to overseas markets); *supra* notes 299-303, 311-20 and accompanying text (analyzing Japan's regulations over derivatives markets through SEL and MOF's tight supervision).

360. *See* Hirsh, *supra* note 328, at 38 (noting that talent and new products are exiting Japanese financial markets in favor of overseas markets, such as Singapore, Hong Kong, United States, and Great Britain and that Japanese markets are "becoming just a local affair within the international marketplace").

overseas.[361] Japan can claim this capital by retaining its structure and not conforming to the projected U.S. model by increasing regulations. Capital flight from the U.S. markets may thus translate into capital investment in the Japanese markets.

In determining how to regulate the derivatives markets, Japan should favor the free-market solution of less centralized regulations.[362] Japan's deregulation of its markets in the 1970's enabled the creation of the derivatives markets.[363] Japan should

---

361. *See* Thomas A. Russo & Marlisa Vinciguerra, *Financial Innovation and Uncertain Regulation: Selected Issues Regarding New Product Development*, 69 TEX. L. REV. 1431, 1439 (1991) (claiming that U.S. competitiveness in global capital markets has been threatened under its current regulatory structure because trading firms seek to avoid CEA's burdens and litigation expenses by futures exchanges by taking their innovative products to overseas markets); *supra* notes 254-74 and accompanying text (describing U.S. futures trading under CEA); *supra* notes 257-61, 264-67 and accompanying text (listing regulations imposed by CFTC, through mandate of CEA, on futures trading).

362. *See supra* note 7 and accompanying text (discussing free market solution by example of response to Barings losses by exchanges and firms that were involved); Suzanne McGee, *'Plain Vanilla' Derivatives Can Also Be Poison*, WALL ST. J., Mar. 20, 1995, at C1, C14 (suggesting that collapse of Barings PLC, which involved poorly managed bets on futures and options "listed on closely supervised exchanges," supports need for review of internal risk management controls rather than broad-based regulations within industry); G. Bruce Knecht, *Troubled Bankers Trust Faces Some Gut-Wrenching Decisions*, WALL ST. J., Mar. 17, 1995, at C1 (noting that free market forces prevailed by punishing Bankers Trust because its stock fell 13% and it will be compelled to adopt less sophisticated derivatives strategy in order to convince investors that its operations are economically sound).

363. *See* KHOURY, *supra* note 8, at 107-08. Forced to deregulate its financial system after the oil crisis of 1973-1974, Japan pursued a leadership role in international competition that would have been impossible had Japan "remained a protected market." *Id.* "One-sided internationalism was neither possible nor a stable long-run condition." *Id.* at 108. The oil crisis of 1973-1974 motivated Japan to deregulate its financial markets because its GNP declined from 10% per year to 3.6%. *Id.* at 106; *see supra* notes 98-101 and accompanying text (noting large Japanese government and public sector deficits following 1973 disruption of market forces for oil prices, which initially caused economic downturn in Japanese economy). Because the banks began to lend increased capital to the government to fund the deficit, corporations relied less on banks, instead turning to financial markets for capital requirements. KHOURY, *supra* note 8, at 106; *see supra* notes 104-05 and accompanying text (explaining minimal deficits in corporate sector after oil crisis and lower bank lending to corporate sector because of falling demand for new plants and equipment). The deregulation of Japanese financial markets after the oil crisis "gave Japanese institutions greater freedom" to invest in the markets. KHOURY, *supra* note 8, at 109. Derivative products were an outgrowth of this deregulatory movement as Japanese financial institutions demanded hedging capabilities. *Id.* at 110; *see supra* note 180 (defining hedge as financial position taken to offset risk of loss inherent in another position); *see also supra* note 196 and accompanying text (describing how derivative products enable users to insulate themselves against fluctuations in valuations of underlying assets); *supra* note 3 and accompanying text (noting beginning of Japanese financial futures market in 1985 and defining futures).

not choke off the growth of derivatives. As useful investment tools, derivatives attract capital to an economy, an important consideration in the present competition for global capital.[364]

CONCLUSION

Japan should rebuke its tendency to follow the U.S. response toward tighter regulations, instead adopting a free-market strategy by reducing restrictions in Japanese financial derivatives markets. The MOF, slow to respond to the increasing competition for global capital and the resultant outflow of capital from Japanese financial markets, should adopt a new strategy for derivatives. As useful investment tools, derivatives have grown popular among global investors, exceeding twelve trillion dollars in world-wide notional value. In recognition of this phenomenon, the MOF should alert Japanese and non-Japanese investors that it intends to promote increased investment in derivatives and thus compete with more loosely regulated economies, otherwise known as emerging markets. By loosening its stranglehold over the economy, the MOF will improve economic efficiency by supporting widespread derivatives use in Japan. Adopting a deregulatory approach to derivatives achieves the dual objectives of supporting valuable investment tools and becoming a powerful competitor in the modern era of global capitalization.

364. *See supra* note 7 (proving globalization of capital markets with statistical support). Estimates of the total value of outstanding derivative contracts reached several trillion dollars in 1994. *The Beauty in the Beast, supra* note 2, at 21. Despite concern that derivatives may make a financial system more vulnerable to losses, huge global markets would not have emerged unless derivatives made good financial sense for all types of users. *Id.* at 22.