

The Role of Law, Legal Infrastructure and Legal Institutions for Financial Stability and Economic Development in the Globalisation of Financial Market

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I Introduction

In the recent globalised financial markets, the role of law including legal infrastructure and legal institutions are getting more and more important to maintain the financial stability and economic development. The purpose of this paper is to analyse the problems of current financial markets from both historical and comparative perspectives, and to describe how law, legal infrastructure and legal institutions solve those problems. Particularly, I will exemplify the case of Japan to figure out how the lack of appropriate legal institutions deteriorates the soundness of financial markets.

First, I will discuss about historical background of globalisation of financial markets.

Second, I will analyse the role of regulations of respective financial industry, i.e., banking, securities and insurance.

In addition, I will describe the challenges for those financial regulations posed by both too much segregation of financial industries (i.e., Japan) and the development of financial conglomerates on the other hand and how the regulatory has responded to those challenges.

Last, the relevance of law, legal infrastructure and legal institutions discussed herein with the financial stability and economic development will be further analysed with reference to the exemplification of Japan.

II Globalisation of Financial Markets

1. The Bretton Woods International Economic System (1944-1973)

Bretton Woods Framework was established by International Monetary and Financial Conference of United and Associated Nations in 1944 to prevent international economic instability and had continued to exist until 1973.

This Framework, based on the fixed exchange rates between major currencies, was designated (1) to reduce the volatility of currencies and (2) to reconnect closed national markets to each other into a structured relationship. It is characterised as “an institutional framework overseen by an intergovernmental organisation”.¹

The main players were: IMF (International Monetary Fund) for monetary policy; the World Bank for financial policy; and the WTO (World Trade Organisation) for trade policy.

2. The Oil Shocks (1973-1982)

The above-mentioned Bretton Woods Framework collapsed as the superiority of United States economy became less prevailing and significant international financial markets outside the ambit of specific domestic markets, the so-called ‘Euromarkets’ emerged. Accordingly, the system of fixed exchange rates was replaced by market-determined fluctuating exchange rates.

Actually, these market-determined fluctuating exchange rates greatly facilitated international communities to survive oil crisis in 1973-1974.

This era can be characterised as the dual structure composed of the closed-national financial markets and the euro-international markets

1 M. Giovanoli, “A New Financial Market: Legal Aspects of International Financial Standard Setting” in M. Giovanoli (ed.), *International Monetary Law: Issues for the New Millennium* (Oxford: OUP 2000), ch. 1

broadly covering the former.

While under the Bretton Woods Framework, the international co-operation was simply attained by the compliance with the rules set by IMF, during this period, the solutions for respective problems were adopted through the negotiation among members of Group of 10 (G-10: Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the U. K. and the U. S.). This was because the further development of financial globalisation and the imbalance between the exchange rates of major currencies required international governmental co-operation.

3. LDC Debt Crisis (1982-1989)

During this era, the importance of international co-operation regarding financial markets was emphasised more strongly than before because of the low developed countries' debt crisis.

Countries such as Mexico and Argentina announced insolvent and asked the creditors for rescheduling of their debts. It led to the loss of confidence in the financial systems and creditor countries were required to negotiate for restructuring such LDC debts.

The co-operation regarding not only foreign exchange rates but also overall fiscal and financial policy was recognised essential. Accordingly, Plaza Accord in 1985 and Louvre Accord in 1987 represented the landmark in that the participants co-operated in terms of financial policy to such extent as to affect member's domestic economy so substantially. For example, the "Bubble Economy", the burst of which seriously deteriorated Japanese economy and led to the recession to date, was caused by the co-ordinated intervention to correct the dollar appreciation and subsequent reduction of the concerted bank rate policy for decreasing market rate for expansion of domestic demand.

On the other hand, international co-operation for providing the markets with liquidity greatly contributed to avoidance of the economic collapse on “Black Monday” in October 1987.

In addition, the development of securitisation and increased international competitions among banks made international financial community realise the necessity to respond to the risks inherent with financial transactions and resulted in BIS Capital Adequacy Requirement in 1988.

4. Post Cold War (1989-1994)

Unlike the previous period when the capital transactions had been controlled whereas the barriers for international trades were largely eliminated, in 1980s, the international capital flows were largely liberalised.

5. Global Financial Market (1994-)

(1) The Risks

In the early 1990s, the complete liberalisation of capital flows led to the emergence of the integrated global financial market, which raised many problems as well as increased volatility as follows :

(i) The foreign exchange rates became largely dependent on the capital transactions.

It brought about gaps between the actual foreign exchange rates determined in the above-mentioned way and the theoretical rates that precisely reflect the economic fundamentals (including GDP growth rates, percentage change in prices, macroeconomic indicators such as balance of payments) of respective countries.

(ii) The advances of technological innovation including the computers and telecommunications make it possible for market participants to shift instantaneously even the largest investment from one side of the globe to the other and to carry out transactions in the most sophisticated financial

instruments, including derivatives, where the already large market is mush-rooming.² This has realised 24 hour dealing and rapidly increased the amount of international financial transactions along with possible contagion of risks.

Therefore, the establishment of risk management systems including safety net facilities at both domestic and international levels is considered essential.

(iii) The development of financial technology innovation along with theoretical back grounds such as Efficient Capital Markets Hypothesis (ECMH) and Portfolio Theory gradually eroded the boundaries between the markets and the lack of knowledge and skill in handling such highly complicated financial instruments will easily cause disorders that might affect the foreign markets.

(iv) The consideration for BIS Capital Adequacy requirement made banks deal with more securitised instruments or off-balance-sheet instruments and it exposed financial markets to increased price risks.

(2) Crises

Since 1994, many financial crises occurred all over the world as follows:

(i) Lack of transparency

International investors with too little information suffered from Mexico financial crisis in 1994-1995.

(ii) Political instability caused by the change of administration or the election brought about East Asian financial crises in 1997-1998.

(iii) Introduction of the pegged exchange rates led to Russian financial crisis in 1998 and Thailand currency crisis.

(iv) Weak financial system, i.e., problems of financial regulators and

2 Id.

the lack of infrastructure, contributed to financial crisis in Brazil in 1999.

- (v) Investor “herd” behaviour made even more investors pour their money out in Turkey in 2000-2001.
- (vi) Self-fulfilling crisis in Argentina of 2000-2001 was attributable to the failure in integration of the domestic financial system into the global financial system.
- (vii) Lack of transparency and consistency with administrative system is one of the biggest factors that led Japan to the “lost decade” throughout 1990s after the burst of “Bubble Economy”.

III The Objectives and Risks Addressed by Banking, Securities and Insurance Regulations

1. Banking-Objectives

The objectives of the banking regulation are as follows :

(1) Prevention of Systemic Risk

Systemic risk is the risk that the collapse of one bank could lead bank runs, causing collapse of banking system and the consequent collapse of economic activity generally, and might result in collapse of the entire economy.

Since this risk is the most influential risk over the economy compared to the risks imposed on the other two industries (i.e., securities and insurance), the banking regulation is most elaborately provided in many jurisdictions while some scholars emphasise the superiority of securities-market-centred capital market to bank-centred one.³

In order to deter the systemic risk, a bank regulator is in many cases

3 B. Black, “The Legal and Institutional Preconditions for Strong Securities Markets” 48 UCLA L. Rev. 781 (2001)

responsible for monetary policy and plays a role of the “Lenders of Last Resort”, and many countries have established and maintain sophisticated payment system.

(2) Prevention and Resolution of Financial Institution Crises

In order to respond to this objective, bank regulators try to maintain sound management and internal controls of individual banks through licensing, authorisation or supervision including on-site examinations as an ex ante means and they use the measures such as suspension of convertibility, the “Lenders of Last Resort” function, or deposit insurance scheme ex post.

Pay-off scheme often provokes the anxiety of depositors. For example, in Japan, although deposit insurance system has existed for a long time, it took a long time for the government to implement pay-off system. It was started only in April 2001 partially. And in fact, Japanese government announced that it will postpone the implementation of the complete pay-off until April 2005 which was originally planned to be done in April 2003.

(3) Prevention of Fraud and Criminal Use of the Banking System

To avoid an abuse of banking system is important to maintain confidence in banking. The lack of confidence means that no one is willing to leave her/his money with banks.

(i) Insider and outsider fraud

There are both insider and outsider fraud.

BCCI is the representative case of the former.

(ii) Money laundering

The 11th of September 2001 attack on the United States is the latest turning point for the international financial community.

This incident has made financial regulators all over the world realise

the importance of international co-operation in this area, because a country whose law or legal infrastructure lacks the function to effectively prevent money laundering may find itself facilitating the organised crime which might damage the other countries.

To respond to such problem, Financial Action Task Force on Money Laundering ("FATF") established forty recommendations in 1996 and published a black list in which the names of countries not complying with FATF's requirements.

The legitimacy of the attitude of FATF is doubtful because ① they set standards based on the agreement among only small number of countries (lack of democracy); ② they lack wide consultation procedure; ③ no opportunity to explain or appeal is provided; ④ the standards are enforced without transparent review.

However, it is true that non-compliance with international requirements to avoid money laundering might exile that country out of international financial markets and result in collapse of its financial stability.

(4) Consumer Protection

The problem of information asymmetry always exists between a bank and its depositors. For example, depositors have hardly any way to scrutinise the creditworthiness of the borrowers to whom the money of them ultimately goes as precisely as the bank. Therefore, it is essential for the protection of depositors or other consumers transacting with banks.

Deposit Insurance is one of the most frequently used tools. However, there is an argument that deposit insurance has undermined the incentives of depositors to monitor excessive risk-taking by banks. As a result, bank managers are free to pursue excessively risky strategies since depositors simply rely on the safety net.

- (5) Maintenance of Sound Competition in the Banking Industry
- (6) Improvement of Financial Market Efficiency
- (7) Moral Hazard

Banking regulators should carefully play a role of “Lender of Last Resort” to prevent moral and morale hazard risks.

2. Securities

In accordance with International Organisation of Securities Commissions (IOSCO), “Objectives and Principles of Securities Regulation (Montreal: IOSCO 1998), the objectives of securities regulations are :

- (1) Protection of Investors
- (2) Ensuring that Markets are Fair, Efficient and Transparent
- (3) Reduction of systemic Risk

Unlike the banking regulation, the feature of securities regulation is to regulate market participants and market itself in addition to the members of securities industries (i.e., securities companies, investment banks or brokers).

- (4) Corporate Governance

To have good corporate governance system including company law and other legal institutions is also important because those who buy stocks through securities market will become co-owners of that company.

3. Insurance

The risks inherent with insurance industry are substantially different from the above two industries.

Insurance is an arrangement to price and manage risks over long-term period. Therefore, the most important duty of an insurance company is to make sure to charge enough premiums for the amount set to payout for the customer in the case of the occurrence of a certain event.

As a result, the objectives of insurance regulation are as follows :

(1) Internal Objectives

- (i) Financial Solvency and Solidity
- (ii) Fairness, Equity and Reasonableness
 - (a) Information Asymmetry
 - (b) Disparity of Bargaining Power
 - (c) Detrimental Reliance and Reasonable Expectation
 - (d) Moral Hazard and Morale Hazard
- (iii) Efficiency of an Insurance Market
 - (a) Elimination of Market Failure Costs
 - (b) Establishment of Industry Practices

(2) External Objectives

- (i) Political Aspect
 - (a) Local Protectionism
 - (b) Liberalisation of Insurance Service
- (ii) Economic Aspect
 - (a) National Economy
 - (b) Accumulated Insurance Fund
 - (c) Foreign Exchange Issue
- (iii) Social Aspect
 - (a) Availability Issue
 - (b) Affordability Issue

IV The Challenges for Financial Regulation Posed by the Development of Financial Conglomerates

1. World-wide Trend for Financial Conglomerates

(1) The United States and Japan

I have explained the objectives and risks of the regulations of each industry. However, a world-wide tendency is for banks to become

multifunctional institutions (“universal banks”).⁴ For example, the United States, on the 12th of November 1999, enacted the Gramm-Leach-Bliley Act which has substantially abolished the segregation of banking industry from securities and insurance industries through providing for a financial holding company system and the amendment to articles 20 and 32 of Glass-Steagall Act, etc.

In Japan, which used to have the similar policy as the United States represented by the article 65 of the Securities & Exchange Law (“SEL”), Financial System Reformation Law in 1993 has enabled a bank to be engaged in securities business through its securities subsidiaries⁵. In addition, the amendments to Anti-Monopoly Law (1997) and Banking Law (1998) provided for a financial holding company, which has been actually used as a tool for the alienation of big commercial banks⁶. For example, from April of 2002 on, the Mizuho Financial Holdings is supposed to have four subsidiaries: Mizuho Bank (a retail banking company); Mizuho Corporate Bank (a wholesale banking company); Mizuho Securities (a securities company); and Mizuho Trust Bank.

(2) Rationales for Financial Conglomerates

Basically, the development of financial conglomerates is on the right course towards financial liberalisation.

(i) Risk Concentration

The failure of two banks out of three long-term credit providers, i.e.,

4 R. Cranston, *Principles of Banking Law* (Oxford: Clarendon Press 1997), p100

5 Most of the Japanese commercial banks had established their securities subsidiaries since the Industrial Bank of Japan (“IBJ”) took the initiative in July of 1993. However, as of December 2001, the number of such securities subsidiaries is less than half of that period through merger, acquisition or failure.

6 For example, in October 2000, the Mizuho Financial Holdings, which is currently the world-biggest financial group, was established by the Dai-Ichi Kangyo Bank (the previous employer of the author), IBJ and the Fuji Bank.

the Long Term Credit Bank and the Nippon Credit Bank in 1998, which symbolises a collapse of Japanese financial system, can be attributed to the segregation policy of Japan, which goes too far. Japanese financial policy has originally divided the nation-wide bank industry into three types : commercial banks ; long-term credit banks ; and trust banks. While such kind of strict separation greatly contributed to the fund raising for manufacturing companies during the “rapidly developing era of Japanese economy” in 1960s, the long-term credit banks have been losing its *raison d’être*, as the maturity of Japanese manufacturing industry and financial liberalisation have developed further. The main reason for the two banks to fail is their desperate efforts to extend loans to risky industries in order to survive the competition with commercial banks. The only one surviving long-term credit bank, IBJ, was forced to be alienated with other two big commercial banks⁷.

In other words, the segregation of financial industries may result in the failure of individual financial institutions because of too many concentrated risks imposed.

(ii) Struggle between Industries

As a result of the strict separation of banking and securities business, there have been battles between the banking and securities industries for new financial instruments in Japan as follows⁸ :

If a product does not fall into the definition of article 2 of SEL, banks may handle it while securities companies may not. Unlike the United States, the definition of “securities” is quite limited. In addition, there is “no-rule-means-prohibition” that when no explicit rule exists as to

7 Id.

8 Hideki Kanda, “Finance Bureaucracy and the Regulation of Financial Markets in Japan”, Harald Baum (ed), *Japan : Economic Success and Legal System*, (1997) pp305-319.

whether a particular new instrument is treated as a security defined in the SEL, institutions may not invent or market such instruments.

Therefore, when a certain new financial instrument is to be introduced, the banking and securities industries sometimes fiercely compete and the Ministry of Finance serves as a mediator and delivers the final judgement and rules after negotiations.

While Professor Kanda argues that this “no-rule-means-prohibition” rule makes sense in Japan, I argue neither separation of industries nor such rule is good for financial stability.

First, this kind of system lacks transparency and predictability because the rule is made only after the negotiation participated by the regulator and interested groups.

Second, this kind of strict segregation and large amount of discretion of the regulator may bring about the corruption. It did actually happen in Japan. In late 1990s, many officers of the Ministry of Finance were accused or prosecuted for having been heavily entertained by the banking and securities industries. Among them, the most insulting event of the history of financial bureaucracy was engraved when on The 13th of November 1998, the Tokyo District Court convicted an official of the Ministry of Finance, who was in charge of approval of new financial instruments, guilty for bribery. The reason why this judgement attracted so much attention was that he was a so-called carrier bureaucrat and it is considered the collapse of Japanese bureaucracy system that has arguably brought about Japanese economic success⁹. What constituted a

9 In Japan, the best and brightest graduates of the University of Tokyo are supposed to work for the Government as “carrier bureaucrats” who have passed the first class examination. The employment systems including the speed and degree of promotion and compensation are completely different between “carrier bureaucrats” and “non-carrier bureaucrats”.

crime in this case was receiving treatment of dinners at fancy restaurants and golf games for approving certain new financial arrangements for four securities companies (so-called “Big Four”¹⁰) from 1993 to 1995. Those new financial arrangements were the schemes that provide the investors in securities investment trust with the convenient services: one is to automatically invest a designated amount of money in a particular investment trust and another is to quickly cash the securities without formal redemption procedure. Since those services were supposed to make securities investment trusts similar to deposits, the administrative authority was initially reluctant in reference with the segregation policy.

2. Challenges

On the other hand, there also exist the risks owing to the conglomerates.

(1) Financial Risks

Among risk of a not transparent structure, risk of cross-subsidisation and risk of contagion, the most considerable risk is systemic risk caused by the banking sector, which may affect the other sectors. However, the failure of securities subsidiary might lead to collapse of the parent bank.

In Japan, there have existed lenient conglomerates, widely famous as “Keiretsu” that operates based on the “main bank system”. Even within such looser relationship compared to the parent-subsidiary relationship, the failure of a company belonging to the same “Keiretsu” has heavily damaged the main bank. For example, the principal motivation for Fuji Bank to be a member of Mizuho Group¹¹ is the fact that the failure of Yamaichi Securities and the bank runs regarding Yasuda Trust Bank in 1997, both of which are members of Fuyo Group, deteriorated the market

10 Nomura Securities, Daiwa Securities, Nikko Securities and Yamaichi Securities

11 See n.6

confidence in Fuji Bank too badly for it to survive as a single entity.

In addition, the influence from the non-financial sector might not be controllable.

(2) Regulatory Aspects

Regulatory must take into consideration different standards in different segments, different regulators, “consolidated” supervision and “conflicts of interest”.

For example, before the establishment of Financial Supervisory Agency (“FSA” Currently, Financial Service Agency) in June of 1998, the Ministry of Finance was in charge of financial regulation and supervision in addition to the role of fiscal authority. To maximise the revenue and to supervise financial industries are sometimes contradicted and it was one of the reasons why FSA was established to assume regulatory responsibility.

(3) Civil and Commercial Law Aspects

There are conflicts of interests among creditors, investors, insured persons and shareholders. “Chinese Walls” should separate knowledge within corporation, in order, for example, to avoid insider dealing.

V The Regulatory Responses to the Challenges

1. Domestic Responses

The domestic efforts of principal jurisdictions can be divided into three types :

(1) Institutional Structure

(i) The United States

Since enactment of Gramm-Leach-Bliley Act, the United States has applied the following supervisory arrangement :

(a) Deposit Institutions

- Bank Holding Company : Federal Reserve
 - National Banks : Office of the Comptroller of the Currency
 - State Banks : state bank regulators
 - Thrifts : Office of Thrift Supervision
- (b) Securities : Securities and Exchange Commission (SEC)+state regulator
- (c) Insurance : state insurance regulators

(ii) Japan

Even when FSA was established in June 1998, the planning of financial system framework and the resolution of the systemic failure remained with the Ministry of Finance¹².

However, in July 2000, FSA was reorganised into the Financial Services Agency assuming planning and resolution of the systemic failure. In this sense, the financial regulatory functions were again concentrated on a single authority.

In addition, in August 2000, to respond to the new coming banks whose parents are non-financial sectors, such as Sony Bank and IY Bank, the Financial Services Agency announced “The Financial Reconstruction Commission/Financial Services Agency Press Release Measures for Licensing for and Supervision of New Types of Banks (Operational Guidelines)”

(2) Functional Structure

Unlike institutional structure that focused on the markets, the functional structure classifies the regulators depending on the functions.

There are two types of functional structures : one is one regulator to

12 Yoshihisa HAYAKAWA, “The Japanese Banking Crisis: Historical and Regulatory Aspects”, D. Arner, M. Yokoi & Z. Zhou (eds), *Financial Crises in the 1990s* (London : British Institute of and Comparative Law 2001 forthcoming), ch. 20.

each one function ; the other is one regulator to, to some extent, unified functions.

(i) Australia

The former is represented by Australia as follows :

- (a) Competition : Competition and Consumer Commission (ACCC)
- (b) Market Integrity : Securities, Investments and Consumer Commission (ASIC)
- (c) Prudential : Prudential Regulatory Authority (APRA)
- (d) Financial Stability (Reserve Bank)
- (e) Financial Activities : functional divisions

(ii) The latter is represented by the U.K and Singapore

In the U.K., FSA is responsible for both of prudential and market integrity ; Bank of England assumes the maintain financial stability ; and the Government is in charge of competition.

In Singapore, Monetary Authority is responsible all the financial regulatory functions.

2. International Responses

As international responses, Basle Committee on Banking Supervision, IOSCO, and IAIS have made efforts and published papers, including "Joint Forum on Financial Conglomerates."

The objectives are :

- (1) Replacement of the solo capital adequacy requirements
- (2) Development of techniques on group-wide basis
- (3) Consolidation of heterogeneous financial conglomerates.

VI The "New International Financial Architecture"

1. Overview

As mentioned above, it is difficult to establish uniformed regulatory

structure suitable for the financial conglomerates all over the world because of differences of history and cultures¹³.

It is most important to match regulatory structure with respective financial structure. The financial crises for this decade happened because of the liberalisation to integrate into international financial system without the renovation of the domestic financial systems.

In order to solve the above problems, the "New International Financial Architecture ("NIFA")" to encompass the rules, guidelines and other arrangements governing international financial relations as well as the various institutions, entities and bodies through which such rules, guidelines and other arrangements are developed, monitored and enforced¹⁴ was established.

The principal objective of NIFA is to maintain financial stability through the crisis prevention and crisis resolution.

In order to serve those objectives, NIFA involves standard setting, implementation and monitoring.

The components of NIFA are G-7, G-10 or G-20 in the political context.

Regarding technocratic context, the Financial Stability Forum ("FSF") is responsible for coordination; International Financial Institutions ("IFIs") such as IMF, World Bank, BIS OECD are in charge of monitoring; and International Financial Organisations (IFOs) also play important roles.

2. The Financial Stability Forum

The FSF was established by G-7 mandate of February 1999 whose

13 L. Bebchuk & M. Roe, "A theory of Path Dependence in Corporate Ownership and Governance", 52 Stan. L. Rev. 127 (1999).

14 *Supra*, n1.

purposes are : to promote international financial stability ; to improve the functioning of markets ; and to reduce systemic risk through enhanced information exchange and international co-operation in financial market supervision and surveillance.

Its members are : national authorities (G-7, European Central Bank (“ECB”) and Australia, Hong Kong, the Netherlands and Singapore) ; international financial institutions (Bank for International Settlements, IMF, Organisation for Economic Development and Co-ordination, and the World Bank) ; international regulatory and supervisory bodies (Basel Committee on Banking Supervision, International Association of Insurance Supervisors, and International Organisation of Securities Commissions) ; and committees of central bank experts (Committee on the Global Financial System and the Committee on Payment and Settlements Systems).

FSF established 12 Key Standards for Sound Financial Systems in the following contexts :

(1) Macroeconomic policy and data transparency

There are various kinds of transparency of : monetary and financial policy transparency, fiscal policy transparency and data dissemination.

(2) Institutional and market infrastructure related to insolvency, corporate governance, accounting, payment and settlement and market integrity.

(3) Financial regulation and supervision

3. IMF

The roles of IMF are standard setting, implementation and monitoring.

IMF has set the standards as follows :

(1) Monetary and financial policy transparency : Code of Good Practices on Transparency in Monetary and Financial Policies

(i) Good transparency practices for monetary policy by central banks of which targets are clarity of roles, responsibilities and objectives of central banks for monetary policy, open process for formulating and reporting monetary policy decisions, public availability of information on monetary policy and accountability and assurance of integrity by the central bank

(ii) Good transparency practices for financial policies by financial agencies

(2) Fiscal policy transparency : Code of Good Practices in Fiscal Transparency

This ensures clarity of roles and responsibilities, public availability of information on monetary policy, open budget preparation, execution and reporting and assurance of integrity

(3) Data dissemination : Special Data Dissemination Standard and General Data Dissemination Standard

4. Implementation

It is the most difficult task to ensure that each country implements the abovementioned standards. However, international financial community should implement those standards to avoid contagion of risks and to cherish global economic growth.

In addition, individual countries also have incentives to implement to prevent crisis. Furthermore, the market incentive to have efficient and effective financial system is the strongest.

5. Monitoring

It is also essential to continuously monitor how individual countries comply with the above-mentioned standards.

IMF and the World Bank published “Reports on the Observance of Standards and Codes (ROSCs)” and “Financial Sector Assessment Program (FSAP)”.

Regionally, European Union and NAFTA play important roles and at the bilateral basis, FATF (the United States) greatly contributes.

In the market context, rating agencies such as S & P or Moody’s have significant presence.

VI The Role of Law

What is asked here is the role of law, legal infrastructure and legal institutions in both financial stability and economic development. However, the former is actually a principal precondition for the latter, because today, scholars, governments, international institutions and business recognise that one of the most important aspects of economic development for any economy is financial stability.¹⁵ Therefore, in this chapter I would like to focus on what can facilitate financial stability.

As mentioned above, the Financial Stability Forum enumerated 12 Key Standards for Sound Financial Systems. Among those standards, I will discuss about the importance of market integrity and the role of administrative institutions and corporate governance to facilitate the former.

Japan’s financial crises of these 10 years have proved what an important role market integrity, administrative system and corporate governance play, as legal infrastructure and institutions for financial stability. Therefore, I will examine how the defects of Japanese system have

15 J. Norton & D. Arner, “Hong Kong SAR: Financial and Future as an International Financial Centre”, in J. Norton, C. Li & Y. Huang (eds), *Financial Regulation in the Greater China Area: Mainland China, Taiwan and Hong Kong* (London: Kluwer 2000), ch. 9

deteriorated its financial stability.

1. Market Integrity

Framework of Market Integrity is ensuring market transparency and equal treatment of investors (thus protecting individual investors) and establishing a framework for the proper functioning of the securities market (thus protecting the market as a whole)

(1) Protection of Minority Shareholders

Professor Black argues that a strong securities market rests on a complex network of legal and market institutions that ensure that minority shareholders receive good information about the value of a company's business and have confidence that a company's managers and controlling shareholders will not cheat them out of most or all of the value of their investment.¹⁶ More concretely, to reduce information asymmetry and to avoid self-dealing are most important.

He provides many empirical evidences that countries with stronger legal protection of minority shareholders have larger stock market capitalisation as a percentage of GDP, higher valuation of minority shares, less concentrated share ownership, more public companies relative to population, and higher dividend payout rates.

(i) Disclosure

Concerning the former consideration, the mandatory disclosure is an important legal infrastructure although some studies have, however, raised considerable doubt whether mandatory disclosure improves protection of minority shareholders¹⁷.

The lack of disclosure causes information asymmetry, which will

¹⁶ Supra n3.

¹⁷ G. Stigler, "Public Regulation of the Securities Market", 37 J. Bus. 117 (1964) ; G. Jarrell, "The Economic Effects of Federal Regulation of the Market for New Security Issues", 24 J. L. & Econ. 613 (1981)

ultimately bring about adverse selection problem that honest companies rarely issue shares to the public, because weak investor protection prevents them from realising a fair price for their shares.

(ii) Self-dealing

The second consideration of Professor Black is regarding the prohibition of self-dealing.

Self-dealing is divided into the following two categories :

A : Direct self-dealing, in which a company engages in transactions, not on arms-length terms, that enrich the company's insiders, their relatives, or friends, or second company that the insiders control ; and

B : Indirect self-dealing, in which insiders use information about the company to trade with less-informed investors.

Regarding B insider dealing, there are debates regarding whether insider trading is a social harm or a social good. For example, Professor Henry Manne argues that insider trading is more likely to reveal the true and intrinsic value of shares. This helps to direct resources to the higher valued users. He also states that insider trading encourages senior management persons to work diligently to find new projects. Therefore, insider trading reduces agency costs.

However, not only minority shareholders protection theory argued by Professor Black, but also the following theories may justify the control of insider trading :

(a) Fairness Argument

● Equality Argument

It is not fair to trade on the basis of the information and to make huge profits not available to the typically less well-informed trader.

● Investor Confidence Argument

Insider trading leads to loss of investor confidence in the stock market.

(b) Manipulation argument

Allowing insider trading may provide the wrong incentives as corporate executives may manipulate the market by giving wrong signals to the market.

(2) Transparency

Transparency is necessary for capital markets in order for investors to understand the nature and risks of investing in securities and thereby to prevent the potentially disastrous rise and collapse of stock market bubbles¹⁸.

(3) Corruption

From the standpoint of general financial stability, if corruption is too pervasive, confidence in the financial system will weaken and investment and stability will decrease to such extent that the markets collapse¹⁹.

Particularly, clean and honest judges, prosecutors and regulators are critical as legal institutions because a financial stability cannot be realised if major players can escape liability by bribing them to forgive their trespasses, or to ignore them.²⁰

2. Administrative Institutions in Japan

In order to implement the above legal infrastructure, the role of administrative institutions is important.

In accordance with “Code of Good Practices on Transparency in Monetary and Financial Policies” published by IMF, clarity of roles,

18 J. Norton, “International Co-operative Efforts and Implications for Law Reform”, *Bank Failures and Bank Insolvency Law in Economies in Transition*, R. Lastra & H. Schiffman (eds.) (Kluwer, London 1999), p306.

19 Id.

20 Supra, n3., p804.

responsibilities and objectives of financial agencies; open process for formulating and reporting of financial policies; public availability of information on financial policies; and accountability and assurances of integrity by financial agencies are required.

In addition, “Objectives and Principles of Securities Regulation” published by IOSCO, provides that clear and consistent regulatory processes, which are consistently applied; comprehensive; transparent to the public; and fair and equitable are essential.

However, the financial administration of Japan has not satisfied most of those requirements and finally led Japan to miserable situation to date.

(1) Lack of Transparency

(i) Large Discretion of Administrative Officials

The law and regulations regarding financial institutions set forth a broad outline and basic principles for financial activity, and left the details to be decided by the regulator²¹. As a result, administrative officials have large discretion.

(a) Tsutatsu

The previous financial regulator, the Ministry of Finance (“MOF”), had long used “Tsutatsu”, which is an administrative guidance to direct financial institutions, as the most important communication tool. Tsutatsu was neither publicly available nor subject to judicial review and made the financial administration less transparent.

To respond to the criticism for such kind of non-transparency, in 1993, the Administrative Procedure Law was promulgated to abolish Tsutatsu administration.

(b) Aural Communication

²¹ Akiko Karaki, “Regulation and Compliance in Japanese Financial Institutions”, 14 CLMJAL 328, p343.

The important directions were sometimes given only orally to the financial institutions, not even in a form of *Tsutatsu*, and they brought about a lot of problems.

For example, in 1991, many Japanese securities companies were heavily criticised for “Loss Compensation” (compensating securities losses to its best customers)²². This kind of practice to discriminate investors deteriorated public confidence in securities markets. However, incredibly, prior to the amendment to the Securities and Exchange Law (“SEL”) in 1991 to respond to this problem, loss compensation was not formally illegal. In addition, it was widely acknowledged by market watchers that loss compensation was indeed informally supported by MOF’s securities bureau²³. It was because MOF, at that time, considered it more important to stop “*Tobashi*” transactions (transferring depreciated assets of a certain customer quietly to another customer whose closing date for account is different from the former for window dressing), which were also prevailing. *Tobashi* was normally executed through “*Business Tokkin*” accounts (a trust vehicle through which a customer delegates the power a securities company to invest her/his money in securities, provided by trust banks), therefore, in December 1989, MOF published a *Tsutatsu* to substantially prohibit “*Business Tokkin*”. In order to abolish *Tokkin* accounts, many securities companies had to compensate the existing customers whose accounts already had huge losses owing to the slump of stock prices beginning at early 1990s. MOF intentionally overlooked this practice.

In addition to the amendment to the SEL, in 1992 the Securities and Exchange Surveillance Commission was revived after 40 year blank to

²² *Id.*

²³ E. Keehn, “Virtual Reality in Japan’s Regulatory Agencies”, *supra*. n. 8. , p323.

respond to those scandals.

However, as widely witnessed, MOF has continuously failed to prevent “Tobashi” practice which is against disclosure theory, and window dressing through “Tobashi” finally led Yamaichi Securities and the Long Term Credit Bank to failure in 1997 and 1998.

Lack of Neutrality

Japanese financial institutions used to have “MOF-tan” (personnel in charge of liaison with MOF). “MOF-tan” was considered the most prestigious position within a financial institution and indeed most of the presidents of banks used to be “MOF-tan”.

In addition, Japan has a notorious Old Boy network²⁴ consisting of retired government officials who “Descend from heaven” (Amakudari) into the boardrooms of private corporation in order for the latter to get necessary information. This tendency is so eminent in financial industries that many banks (including Nippon Credit Bank that failed in 1998) customarily appoint previous vice minister or another high-ranked MOF official as its president. This phenomenon is attributable to the high uncertainty of situational regulation through administrative guidance²⁵.

Financial institutions actually obtained the information even regarding the date of on-site examinations from the MOF and Bank of Japan through such communications, which ruined the supervision system.

Corruption

Lack of transparency caused corruption as well.

The main job of “MOF-tan” was to entertain the relevant officials at restaurants or to invite them to golf games, because the best way to get

24 U. Schaefer, “The ‘Old Boy’ Network and Government-Business Relationships in Japan”, *supra*. n. 8. Pp345-369.

25 *Id.*

important information is to establish close and friendly relationship.

In late 1990s, 45 persons of both administrative and private financial institutions were arrested for bribery, and more than 200 officials of MOF and Bank of Japan were internally penalised for receiving too much entertainment from the relevant financial institutions.

Among them, a member of the Diet, Shokei Arai, who was about to be arrested for receiving loss compensation from Nikko Securities, committed suicide in February 1998.

(2) Lack of Competition

(i) Convoy System

The MOF's policy of setting a standard that would match with the weakest member of the sector caused moral hazard problem.

(ii) Segregation of Financial Business

Too much segregation of financial regulation disturbed a sound competition as well as brought about corruption.²⁶

3. Corporate Governance in Japan

Corporate governance is also important to protect minority shareholders, however, Japan's system is not sophisticated enough.

(1) Mutual Shareholding

The "Keiretsu" and mutual shareholding scheme in which main bank system plays an important role discourage minority shareholders to be interested in corporate governance.

(2) *Sokaiya*

According to the legal theory, the owners of the company are shareholders, however, in the reality, the virtual owners of the company are directors and employees²⁷. As a result, once a year, the day of annual

²⁶ See IV

²⁷ E. Takahashi, "Changes in the Japanese Enterprise Groups?", *supra*. n. 8, p235

shareholders' general meeting is the only opportunity when a company must be exposed to the world of legal theory. In accordance with the duty of accountability, the management of the company shall answer to any question raised by shareholders at the general meeting.

The most of the listed companies set the same date (late June) for their shareholders' general meeting to make it impossible for assertive shareholders to attending. Therefore, so-called rogue shareholder, or *sokaiya* has abused this system. *Sokaiya* receives compensation from the company for co-operating to ensure that the general meeting runs smoothly by simply saying nothing knowingly the scandals of the company, or by bullying the other shareholders.

In 1997, the directors of major financial institutions have been arrested for benefiting *sokaiya* and those became the Japan's biggest economic scandal after the last war.

Responding to the scandals, 1997 Amendment to the Commercial Code made it a criminal offence for a shareholder to merely request a company to compensate for the exercise of shareholder's rights as well as the strengthening of punishment.

4. Conclusion

Japan's recent situation shows how important the role of law, legal infrastructure and legal institutions is for financial stability (and thus economic development).

Of course Japan's crisis can be attributable to the unlucky combination of financial liberalisation, financial globalisation and the burst of bubble economy, however, the A class war criminal is the administrative system. The Japanese style administration is now proved to be suitable only for closed domestic economy which is on upward.

Apart from the phenomenon mentioned above, my 14-year experience

as a manager of a Japanese bank tells how financial regulator lacked definite opinion and just opportunistically responded to international trends (i.e., BIS capital adequacy requirement, money laundering, etc.).