

National Institute for Research Advancement

Policy Research Report

NIRA Market Governance Report 2005

**Proposal for Enactment of
a Japanese Financial Services and Markets Act**

< Outline of the Research >

This research project proposes the establishment of comprehensive and cross-sectoral market laws. Recognizing that it is essential to drastically reform the market regulation systems currently in place in Japan from the perspectives of the public and market participants, the project led to the establishment of a Grand Design for the Enactment of a Japanese Financial Services and Markets Act.

NIRA believes that this proposal will contribute to the resolution of an issue of the greatest importance and urgency for Japan: the establishment of superior markets that ensure fair price formation, and, as a prerequisite to the achievement of this objective, the creation of an enhanced systemic or "soft" infrastructure regime, including new rules and regulations.

Research Objectives

1. Identification of principles for market legislation suited to the 21st century
2. Establishment of a Grand Design for the Enactment of a Japanese Financial Services and Markets Act and a schedule for its implementation
3. Proposal for effective alternative dispute resolution (ADR) systems
4. Outline proposal for cross-sectoral public services legislation
5. Stimulation of public debate

Overview

Financial Services and Markets Act

The systems currently governing Japan's markets are clearly suffering from institutional fatigue, as evidenced by the numerous dangerous gaps and inconsistencies between laws and regulations. Additional problems reveal themselves in the current industry laws, the inadequacy of the vertically compartmentalized supervisory authorities, and deficiencies in the investment services law currently under deliberation. It is for these reasons that NIRA has proposed, for the first time in Japan, a comprehensive and cross-sectoral Grand Design for the Enactment of a Japanese Financial Services and Markets Act, born of a collaboration among the public sector, academia, the private sector, and research institutions. This initiative is being undertaken in recognition of the fact that prompt and dramatic reform designed from the perspectives of the public and market users is imperative.

Concept of a Japanese Financial Services and Markets Act

(concerning implementation of a framework for ensuring market functions, categorization of market participants into professionals, semi-professionals, and non-professionals, and roles and special characteristics of self-regulating institutions, ADR, etc.)

In terms of rapid response to change, there is a limit to what can be achieved solely through the provision of statutes. However, examples from the past also teach us that a great deal of damage can be caused by relying solely on the discretion of financial authorities. Flexibility must be built into the structure of the system itself or laws will not be sufficiently effective. For this reason, NIRA has proposed as the ultimate goal the creation of a comprehensive, cross-sectoral Japanese Financial Services and Markets Act as an open and flexibly structured system, to be modeled after the UK's Financial Services and

Markets Act (FSMA) 2000 (which was based on the 1986 Financial Services Act and drafted over a period of four years), with particular attention to the FSMA's emphasis on principles and its positioning as a framework legislation.

When markets are dysfunctional, innate market functions are suppressed, and no amount of patchwork measures to assist victims will prevent further problems. If the objective is fundamental protection of individual investors and the consumers of financial services, the first market function to guarantee is fair price formation. A Japanese Financial Services and Markets Act must first and foremost be understood as a market law, not as a consumer protection law. Competitiveness should be fostered in financial and capital markets and among financial service providers by increasing market integrity through the establishment of a cross-sectoral and comprehensive system of market laws; robust consumer protection measures should be put into place at the same time.

This concept of a Japanese Financial Services and Markets Act does not merely propose the provision of legislation, but the construction of a framework of laws and regulations as an organic system based on clear principles, which covers the following issues:

- Self-supervision and governance of the regulatory and supervisory institutions
- Enforcement by regulatory and supervisory institutions
- Compensation schemes (safety net)
- Appropriate ADR (out-of court dispute resolution institutions—i.e., ombudsman scheme)
- Cost and effectiveness of the system, with consideration of the comprehensive integration of not only legal systems but also regulatory institutions, compensation schemes (safety net), and ADR, etc., considered comprehensively as a single package.

This proposal for a Japanese Financial Services and Markets Act delineates what may be considered the ultimate goals for Japan in this field. Only through its implementation can the as-yet-unfinished process of the “Big Bang” financial market reform finally be completed.

Together with the Grand Design, NIRA has also proposed an action

plan—with the enactment of the Investment Services Law by 2007 as an interim objective—envisaging ultimate implementation of a Japanese Financial Services and Markets Act by 2009. By this date, the dematerialization of securities will have been completed, and “negotiable securities” will take on an entirely different meaning.

In order to achieve this ultimate goal, NIRA has also proposed the establishment of a non-ad-hoc forum for deliberation—to be under political leadership and separate from the Council on Financial Services—involving cooperation between the public sector, academia, the private sector, and research institutions.

The provision of new systems of laws and regulations to enhance financial markets will have clear benefits: (1) Economic efficiency will be enhanced through the reduction of transaction costs; and (2) Confidence in markets and market transactions will be increased through the achievement of statutory fairness.

With regard to item (1) above, our estimates indicate the potential for a 0.2% reduction in financing costs (cost of capital) if the functioning of Japan’s financial markets is improved. Further, according to our estimates, if reforms are implemented as envisioned, after seven years real GDP will have increased 0.55% (compared to status quo). Based on GDP figures for fiscal 2003, this corresponds to ¥2.9 trillion.

If the budget allocated to market system reform does not exceed subsequent increases in tax revenue, it will not be necessary to increase JGB issuance or raise taxes for the implementation of reforms. Our estimates indicate that the increase in tax revenue (approximately ¥274 billion per year on average) generated by GDP growth following reforms will be far higher than the current budget of the Financial Services Agency (approximately ¥17.1 billion in fiscal 2004). A simple comparison of these figures suggests that market system reform can be carried out in tandem with an expansion of financial supervisory systems with a budget allocation well within the scope of increased tax revenues. If market reform can be achieved on these terms, it will potentially be of greater benefit from the perspective of infrastructure provision than projects for the construction or upgrading of roads, airports, etc., which bequeath a burden of public debt to subsequent generations and do not provide benefit concomitant with cost. The

establishment of a new legal system is clearly the most fundamental and the most important core issue of this structural reform.

Estimate of GDP growth following enhancement of financial and capital markets through introduction of new laws and regulations

	Growth in real GDP seven years after implementation of reforms (compared to status quo)
Estimate of benefit of enhancement of Japan's financial markets in this report (premised on a reduction of 20bp in financing costs)	0.55% (approximately ¥2.9 trillion*) * converted on the basis of real GDP for fiscal 2003
Estimate by London Economics (2002) of the effect of integration of financial markets in the EU (premised on declines in average financing costs in EU member economies of 50bp, 40bp, and 20bp for equity, bonds, and loans respectively)	0.90% (after standardization of maturities)

Moreover, in order to realize the common objectives of anti-monopoly laws and industry laws—the promotion of fair competition (including in the financial sector)—based on their mutually supplementary relationship, NIRA proposes to remodel the current silo-style industry laws that exist separately for each industry and type of business into a comprehensive and cross-sectoral system that accords with individual market realities.

*(Shigehito Inukai,
Senior Fellow, NIRA and
Visiting Professor, Waseda University)*

Members of the Research Group

Tatsuo Uemura, Professor, Waseda University

Kazuaki Sono, Emeritus Professor, Hokkaido University

Keiji Matsumoto, Lawyer, Mori/Hamada & Matsumoto

Hideki Kanda, Professor, The University of Tokyo

Satoshi Negishi, Professor, Kobe University

Naoyuki Yoshino, Professor, Keio University

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Shigehito Inukai, Senior Fellow, NIRA (Project Leader)

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For further information, please contact the Planning and Public Relations Division at pprd@nira.go.jp.

<<About NIRA>>

The National Institute for Research Advancement (NIRA) is an independent policy research body established on the initiative of leading figures from Japan's industrial, labor and academic communities. The Institute was founded in 1974 under the National Institute for Research Advancement Act and is funded through an endowment of capital contributions and donations from both the public and private sectors.

NIRA's primary objective is to conduct independent research from a long-term perspective that will contribute to the resolution of a variety of complex problems facing contemporary society. To this end, in addition to conducting its own comprehensive research program, NIRA works actively to disseminate research results and to promote exchanges and joint research projects with numerous domestic and foreign institutes.



Yebisu Garden Place Tower, 4-20-3, Ebisu, Shibuya-ku, Tokyo 150-6034, Japan

Tel: 81-3-5448-1735 Fax: 81-3-5448-1745

<http://www.nira.go.jp/>