The Livedoor Incident and the Japanese Stock Market

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1. The Livedoor incident and its impact on the stock market

1) Livedoor "shock"?

On January 16, the Tokyo prosecutor's office and officials from the Securities and Exchange Surveillance Commission conducted a large-scale domiciliary search of Livedoor and its affiliate companies on suspicion of violations of the Securities and Exchange law. On the following day (January 17), the Nikkei average fell ¥462, the largest one-day drop in the Japanese stock market in 18 months, and then fell by another ¥462 on January 18. This plunge in share prices was widely referred to in the media as the "Livedoor shock."

There was a flood of sell orders for Livedoor's shares from the opening bell on January 17, and these orders went unfilled as one stop-loss order after another was triggered. Over the next four days of trading, until January 20, stop-loss orders continued to be hit, and with the company's market cap falling to half its previous level, there were still sell orders outstanding for 280 million shares – over 26% of the shares outstanding – an unusual situation. Initially, news of the raid by prosecutors' only triggered a sell-off of shares in Livedoor and its affiliates. At the close of the morning trading session on January 17, the Nikkei average was stable, up ¥54 from the previous day's close. This was a scandal involving a specific company, and ultimately a company-specific problem that had absolutely nothing to do with nearly any of the other listed companies. It was therefore only natural that the overall market did not collapse.

Conditions quickly changed, however, midway through the afternoon trading session that day (17th). A flood of sell orders arose in what could be accurately described as panic selling, and 92% of the stocks listed on the TSE-1 fell in price. This "sell-off" atmosphere persisted the following day, and the Nikkei average continued to fall. What could have happened to spark this? The news outlets tried to attribute this to uncertainty or to an overall aversion to the IT sector based on its association with Livedoor, but this does not explain the market's calm during the morning session on the 17th.

2) Reduction in collateral assessment invited market volatility

Our focus is on the notification from the online securities brokerage firm Monex to its clients on the 17th that it was suddenly reducing, to zero from 70-80%, the assessed value of shares in Livedoor and four of its affiliates used as collateral in margin trades. This change forced the company's clients who had used Livedoor affiliated shares as collateral for margin trading to deposit a considerable amount of additional margin funds in cash.

It is easy to imagine how this could lead to a rapid increase in the number of investors who begin selling unrelated stocks in their portfolios. Furthermore, although Monex notified its own clients of the change in collateral value by email, the news was quickly relied via Internet bulletin boards and other means to "frequent trader" individual investors, and concern that other securities trading firms would adopt similar measures began to spread. We think what caused the quick change in the market on the 17th is that the number of these "distress" sell orders by individual investors increased, prompting further sell orders from investors who remained unaware of the change in collateral value.[1]

Subsequently, there was a rising chorus of criticism directed at Monex, with economy and financial services Minister Kaoru Yosano remarking that the firm's move bewildered investors. In response, Monex issued a press release stating "lowering the collateral value of a particular stock was one option open to management," and that when a situation arises in which assessing collateral value becomes difficult, "it is a security firm's responsibility to encourage caution early on in order to protect the profits of individual investors." Certainly it is possible for a securities firm to use its judgment on when to change collateral values used for normal margin trading. Nevertheless, to suddenly and dramatically lower collateral value while the results of the prosecutor's search of Livedoor were still unknown seems to be a lapse in managerial judgment.

Although Monex has also argued that it had a responsibility to protect its own shareholder's value, saying that it lowered collateral values in order to protect shareholder value is tantamount to arguing that it is prepared to destroy the profits of the individual investors who are its customers when necessary to protect shareholders. If the true intent was to "provoke early caution" as argued, then it would have been enough to merely send an email warning doing exactly that. It was perfectly clear to

[1] Monex published on its Website an opinion, dated January 19, that it "did not believe there was any causal relationship between its reduction of the assessed collateral value of five stocks and the volatility of share prices in the broader market that has occurred over the past few days." Nevertheless, stock market movements on the 19th and 20th strongly suggest that the market's plunge on the 17th and 18th can be attributed to temporary supply-demand factors.

its clients that the collateral value of Livedoor affiliated shares would decline in step with the share price. There should not have been any need to put further pressure on investors by lowering the collateral assessment and thus raising the required margin deposit. We are in no way making the extreme argument that all of the market's movement from the afternoon session on the 17th was owing to the impact of this change in collateral assessment, but we think it would be difficult to argue that Monex's move was not one of the factors that roiled the market.

3) Suspicions hanging over Livedoor

What probably directly led to the domiciliary search was the announcement by Livedoor subsidiary ValueClick Japan (now Livedoor Marketing) that it would make Money Life, a publisher of magazines offering money-related information, into a wholly owned subsidiary. This was a suspected violation of Article 158 of the Securities and Exchange Law, which prohibits the spreading of rumors or the use of fraudulent means to trade in securities or attempt to manipulate the market.

A press release issued at the time described the addition of Money Life's financially focused advertising media to ValueClick Japan's Internet advertising business as "expected to generate substantial business synergy." Furthermore, although it was noted that the VLMA2 investment trust owned 100% of Money Life's shares, there was absolutely no explanation of VLMA2 itself. In fact, however, VLMA2 was de facto controlled by Livedoor. In other words, Livedoor was suspected of contriving a transaction that merely converted a company already controlled by the Livedoor group into a subsidiary of one of the Livedoor group's listed companies, and then characterizing that transaction as a corporate acquisition with the potential for realizing "substantial business synergy."

Furthermore, ValueClick Japan decided on a 100-to-1 split of its shares immediately after the acquisition was announced. Since trading in these shares was extremely light during the approximately 50-day period between announcement of the major stock split and actual issuance of the new shares, the announcement could easily cause a huge upswing in the share price temporarily.[2] Since ValueClick Japan was acquiring Money Life through an exchange of shares, VLMA2 investment trust, the owner of Money Life's stock, would acquire shares in ValueClick Japan. And since these shares rose sharply in value, the acquisition indirectly resulted in profits for Livedoor itself. Not only was the information disclosed by ValueClick Japan misleading, it now looks possible that the entire set of transactions was fraudulent.[3]

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2 This problem has been solved with a new law, effective January 4, that allows trading in new shares beginning the day after the effective day of the stock split.

3 In addition to this, there were also suspicions that Livedoor doctored its results for the period ended September 2004.

In the past, stocks were governed under par value rules, and the commercial code prohibited stock splits that reduced the value of net assets to below ¥50,000 per share. The objective was to curtail the fractionalization of equity ownership increments. It is not unusual for a rapidly growing venture firm to achieve a share price toward the end of its fiscal year that becomes way out of step with the book value of its assets as recorded at the end of the prior fiscal year. Consequently, the restrictions in the commercial code wound up becoming an obstacle to the formation of investment units of optimal size. For example, in January 2000 Yahoo Japan's share price rose above ¥100 million. The company had announced 2-for-1 stock splits every six months since March 1999, but even after the fourth stock split its share price was ¥30 million, beyond the reach of the typical individual investor. A revision to the commercial code in October 2001 made it possible to carry out large-scale stock splits that had been prohibited until then.

All that a stock split does is divide the outstanding shares into smaller pieces; it does not affect the company's assets. Logically, therefore, it should have absolutely no effect on the value of the shares. In the case of a 10-for-1 stock split, the quoted price of a share of stock should decline to one-tenth of it level prior to the stock split. In the actual market, however, since stock splits are done out of an expectation of substantial gains in the share price, they are taken as a signal of management's bullish outlook, and thus tend to act as a positive catalyst and push the share price higher. When combined with the temporary lull in trading volume resulting from the wait for issuance of new shares, as touched upon earlier, it becomes possible to engineer an increase in the share price by conducting a large-scale stock split. Livedoor pursued a series of stock splits, starting with a 100-for-1 split in February 2004 and then following that with another 100-for-1 and then a 200-for-1 split, but not without regard for the market impact from a temporary worsening of supply-demand resulting from the splits. In fact, it seemed to pursue these stock splits with what could only be described as an intention to turn that market impact into a favorable one. During this process, as the large-scale stock splits resulted in a flood of new shares on the market, the company bought back shares to further tighten the balance between supply and demand.

Considerable criticism arose over Livedoor's handling of the stock split, which seemed to be at odds with what a stock split is supposed to be aimed at: making it easier for small investors to invest in the stock. In March 2005, the Tokyo Stock Exchange (TSE) asked listed companies to exercise restraint with large-scale stock splits, while also encouraging investors to be cautious. Nevertheless, the companies conducting large-scale stock splits were not fazed by the criticism, maintaining that the stock splits were not prohibited by law. Livedoor's management methods had already come under scrutiny by the judicial authorities, but the company remained defiant, arguing that it could do as it pleased as long as its actions were not expressly prohibited by the law. A classic example of this was Livedoor's acquisition in

February 2005 of a large block of Nippon Broadcasting shares during after-hours trading.[4]

2. System problems at TSE

1) TSE deals with system uncertainties

On January 18, the "Livedoor shock" took an unexpected turn. Owing to the rapid increase in trades ordered by individual investors, the TSE became concerned that the rising load on its trading and settlement system might prevent the orders from being smoothly executed. On the afternoon of the 18th, the TSE announced that depending on the status of afternoon trading, there was a possibility that it would suspend trading, and in fact it did halt trading at 14:40, 20 minutes prior to the formal close of the session. It also announced that, beginning on the 19th and as a temporary measure until system uncertainties could be resolved, it would delay the start of the afternoon trading session by 30 minutes, and that trading would be allowed under the caveat that it would be suspended once it became clear that the number of orders exceeded 8.5 million or the number of executions exceeded 4 million. The TSE then made some emergency enhancements to its system, allowing it to raise the number of contracts allowed before halting trading to 4.5 million.

There are numerous historical examples in every country of exchange trading being suspended owing to natural disasters, terrorism, or such economic disruptions as a plunge in the stock market or a currency crisis. This is the first time, however, that trading on a country's marquee stock exchange has been halted owing to limits on the processing capacity of that exchange's system.

Trading in Livedoor shares became a critical question mark affecting how serious the TSE's system uncertainties would become. The price of Livedoor shares reached stop-loss limits for several consecutive days from January 17, the first day of trading following news of the domiciliary search. Subsequently, doubt was cast over Livedoor's long-term survivability when its founder and CEO, as well as other top executives, were arrested. In response to the arrests, TSE put the shares of both Livedoor and Livedoor Marketing under "*Kanri Post*" (supervised status), raising the possibility that the shares would be delisted in the future.

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4 In February 2005, Livedoor acquired a large block of Nippon Broadcasting shares using the TSE's after-hours trading system. The legality of this acquisition was questioned, since Livedoor did not follow the procedures for a tender offer. For details, see Sadakazu Osaki, Regulation of Japan's Capital Markets and the Battle for Control of Nippon Broadcasting System, Nomura Capital Market Review, vol.8, no.2.

That said, the actual businesses run by Livedoor are not collapsing, and with the company owning a large number of shares in listed companies that continue to run sound businesses, there has been no loss in the value of its assets. This suggests there is a possibility that Livedoor could be acquired by an investment fund, although it is difficult to say whether this would occur before or after the company's shares are delisted. The value of the company's shares is not going to drop to zero, and some buy orders should come in, based on the perception that the shares are undervalued, and a number of those contracts should be executed.

This has led to concerns that brisk trading in Livedoor shares could put a huge stress on the TSE's system. What is more, Livedoor does not adhere to a minimum lot requirement, and thus its shares can be traded in lots of a single share. Livedoor has over 1 billion shares outstanding, and with many of these shares owned by small investors, the number of shareholders is over 220,000 (as of September 2005).

This listing of 1 billion tradable units is a most unusual case among the TSE's listed companies. Toyota Motors, the company with the largest market cap, has only 36 million tradable units (single lots consist of 100 shares), and the next largest company, Mitsubishi UFJ Financial Group, has 10 million tradable units (with no minimum lot restrictions), numbers that put Livedoor's unusual situation into perspective. If enough buy orders came in to match sell orders exceeding 200 million shares, how many contracts would this result in? Theoretically, if all of the buy orders were for the minimum lot size, it could result in as many as 200 million executions. It is easy to see the destructive impact that trading in Livedoor shares could have on the TSE system.

Consequently, the TSE had no choice but to implement temporary measures limiting the trading hours of Livedoor stock. This has happened before. In April 2004, the Osaka Stock Exchange (OSE) implemented restrictions on the trading of stock in Prime System (now Sunrise Technology), allowing only two trades a day using the single-price auction method (rather than continuous trading). This method (*itayose*) is normally used for openings and closings. It did this when that company's shares became a "money game" target and fell to a price of only several yen. Because conditions failed to improve, the OSE implemented additional measures, including the prohibition of market orders. These exceptional trading restrictions remained in place for half a year, until the company announced a reverse split and order levels returned to normal. Additionally, since June 2005, the OSE has required manual matching for all stocks whenever order levels reach a point where they can put excessive stress on the system.

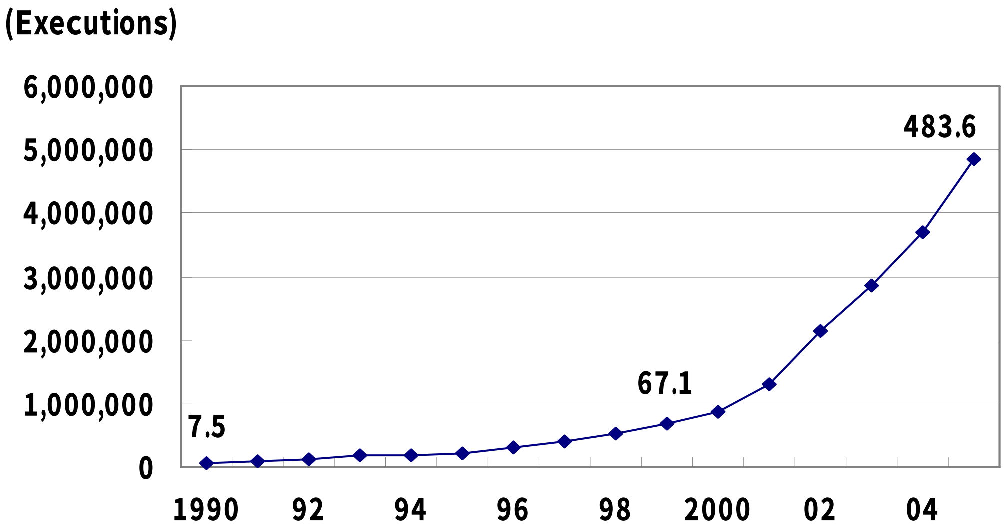
Although it can be said that the mere act of applying exceptional trading rules to stocks that have captured the broader market's attention will inevitably disrupt the market, that is the only way to prevent abnormal trading in a single stock from leading to suspension of trading in the overall market. The TSE's decision to allow the unusual situation of a single listing with 1 billion tradable units, a result of its not raising objections to unusual stock splits and the minimal lot size being set too low, both done under the pretext of lowering the minimal lot size, wound up putting pressures on the system.

2) Why did this situation arise?

The number of orders and executions in the Japanese stock markets has grown at a considerably faster rate than trading volume or trading value over the past few years. Possible reasons for this are as follows. First, the complete deregulation of brokerage commissions in October 1999 led to the spread of online trading and resulted in a substantial reduction in commissions, and this made it possible for day traders and other individual investors to make frequent trades. Second, the Japan Security Dealers Association (JSDA), together with the TSE and other stock exchanges, announced in September 2001 an action program aimed at encouraging equity investment in smaller lots by convincing listed companies to approve stocks splits and lower their minimum trading lots in order to bring the value of tradable investment units down below ¥500,000. The program was a success, and the number of small-lot orders submitted by individual investors increased. Third, the trading technologies used by institutional investors have progressed, strengthening the trend away from large-lot orders that have a major market impact and toward dividing up orders into smaller lots.

In fact, of the three factors noted above, the first and third are not unique to Japan, but rather shared with the US market. In the US, as well, there has been rapid growth in the number of executions over the past few years, with the average number of daily executions on the New York Stock Exchange rising to 4.83 million in 2005, higher than the 4.5 million maximum capacity of TSE's clearance system (see Figure below). Of interest here is that the number of executions recently has risen far above the level seen during the peak of the dot-com bubble in 1999 and 2000.

Average daily executions on the New York Stock Exchange



Source: Compiled from New York Stock Exchange materials.

The New York Stock Exchange has responded appropriately to this rapid increase in executions, and as a consequence there has so far not been a single major problem directly caused by capacity restraints in its trading or settlement systems. This stands in contrast with the TSE, which unfortunately has delayed making improvements to its system.

But this was not a situation that was completely unexpected or impossible to rationally forecast. One issue we would like to examine here is whether the TSE has made any progress in adding capacity to its system, after accounting for the impact from its own efforts to reduce the size of tradable units. This lies as the root of the problem described earlier, in which the system had to be shut down because of trading in Livedoor stock.

As noted earlier, the Japan Security Dealers Association (JSDA), together with the TSE and other stock exchanges, announced in September 2001 an action program aimed at encouraging equity investment in smaller lots, convincing listed companies to approve stocks splits and lower their minimum trading lots in order to bring the value of tradable investments units down below ¥500,000. It seems that at the very least, the TSE should have sufficiently thought through the impact that its calls for lowering the size of tradable units would have on the market.

The table on the following page shows the average daily trading value on the TSE and the number of trades that would equate to if each trade were worth ¥500,000. For example, average daily trading value in 2000 was approximately ¥1.26 trillion, and this would equate to 2 million tradable units if the value of every stock on the exchange were ¥500,000 per unit. If all of these 2 million trades were executed at the minimum size of a single lot, it would equate to 2 million executions.[5]

In other words, the TSE should have realized that even under the market conditions of 2000, if the size of a single tradable unit had been lowered to ¥500 million, there could already have been on average as many as 2 million executions per day, and assuming a peak number only double the average, it should have prepared for the possibility that it would have to handle as many as 4 million executions. Following the same line of reasoning, with the stock market starting to gain momentum from 2004, an average of 3 million executions per day becomes possible, and thus it would not be out of line to expect a peak as high as about 6 million executions.

If trading lot size were ¥500,000

Year (month for 2005)	TSE average daily trading value	Number of trades assuming lot size of \500,000
2000	1,002,673	2,005,346
2001	822,201	1,644,402
2002	785,994	1,571,988
2003	989,270	1,978,540
2004	1,394,801	2,789,602
2005.1	1,368,539	2,737,078
2	1,542,379	3,084,758
3	1,688,120	3,376,240
4	1,440,813	2,881,626
5	1,373,312	2,746,624
6	1,391,252	2,782,504
7	1,424,251	2,848,502
8	1,936,878	3,873,756
9	2,561,198	5,122,396
10	2,687,333	5,374,666
11	3,145,863	6,291,726
12	3,470,866	6,941,732

Source: Compiled from Tokyo Stock Exchange materials

The estimates we provide here are purely hypothetical, and not based on actual growth in the number of executions. Nevertheless, just the above analysis by itself should have made it very clear from the initial planning stages that, once the maximum impact of lowering the value of tradable units is taken into account, a capacity of 4.5 million executions would be insufficient for a next-generation settlement system. The fact that recent growth in the number of executions has vastly surpassed the TSE's forecasts makes one wonder whether the TSE took sufficient account of the impact from lowering the value of tradable units.

5 It would not make sense, of course, that all orders submitted would be for the minimum tradable lot in actual trading, but when considering system capacity it is necessary to look at the theoretical maximum load on the system.

3. Impact of the Livedoor incident on system reform

1) TSE is not responsible

There has been a tendency to use the Livedoor incident as a wedge to point out problems and inadequacies in the systems underpinning the Japanese stock market. A number of points have been made, with one of those being that the TSE's lack of preparation is to blame, based on its having allowed Livedoor's shares to be listed and for having overlooked information disclosures that were misleading.

Nevertheless, the initial listing of Livedoor's predecessor, Livin' on the Edge, occurred in April 2004, right after the TSE's Mothers exchange opened for business, and it is a stretch to claim there were problems with the initial vetting of the listing based solely on actions alleged, in the current uproar, to have taken place in 2004. Additionally, although it is true that the TSE did not see through the fraudulent disclosures, a stock exchange's liability does not extend so far as guaranteeing the veracity of information disclosed on the market. The examination of disclosures is the job of the issuing company and the auditors, and a stock exchange does not have the power to prevent intentional disclosure fraud.

Some observers appear to be framing the current incident as a problem with how the overall market deals with new companies, based on Livedoor having repeatedly secured funding and split its stock on the TSE's Mothers exchange, but this is taking it too far, in our opinion. Since the opening of TSE's Mothers, considerable progress has been made in providing a market for startups. The time required from establishing a corporation until taking it public has been reduced substantially, making it much easier for growing companies to procure funds. Over the past several years, well over a hundred venture firms each year have conducted IPOs in order to fund their growth. Unfortunately, numerous scandals have grown out of markets geared toward startups, including the Livedoor incident. Nevertheless, it is unfair to disparage the significance of a market that has helped transform Japan's industrial structure just because a few companies out of the nearly 1000 that have gone public so far caused a problem. If the Livedoor incident winds up leading to reforms that raise the threshold for companies to enter startup markets, it would be as foolish as throwing the baby out with the bathwater.

2) New rules governing stock splits are not necessary

Second, there has been rising criticism of the large-scale stock splits used by Livedoor and its affiliates as a way to boost their share prices. As noted earlier, however, there is absolutely no problem with the system of stock splits itself. It is the abuse by issuers of mechanisms related to the transfer of shares that is the major problem. Beginning January 4, 2006, it became possible to trade new shares starting the day after the effective date of the stock split, and so far there do not seem to have been any major problems concerning the actual transfer of shares.

Of course, it is important to acknowledge as valid that criticism of how the system was handled and of the slow response of the TSE in demanding self discipline and in warning investors (March 2005). That said, at the risk of sounding repetitive, we would once again note that, at this stage, we see absolutely no need to consider new rules governing stock.

3) No need for new measures to prevent "cooking the books," either

Third, regarding the emergence of suspicions that Livedoor and its affiliates doctored their results, there has a been a rising chorus pointing out the similarities with the Enron and WorldCom accounting scandals in the US and the need to learn from the system reforms implemented in the wake of those scandals. Debate over system reform has already begun in Japan, sparked by the falsified securities filings turned in by Seibu Railway that were discovered in October 2004 and other incidents, including Kanebo's accounting irregularities. Both the Financial System Council and the Business Accounting Deliberation Council have issued reports on the subject.

Some of the recommendations in these reports have already been legislated into law, including the implementation of a system of levying surcharges on companies that include false statements in their regular disclosure documents. Proposed legislation on internal corporate governance modeled on the Sarbanes-Oxley Act in the US has been slated for debate in the current session of the Diet since before the Livedoor scandal broke. Steady progress is already being made in strengthening oversight of certified public accountants, and we do not think that the Livedoor problem is grounds for reopening the dispute over further revisions.

If anything, it may create a new dispute over how to regulate the types of investment business partnerships that were abused by Livedoor. In fact, this was already an issue being debated for inclusion in the Investment Services Bill, which is scheduled for presentation at the current Diet session. The report from the Financial System Council released at the end of 2005 was somewhat negative toward the idea of a system for registration of investment business partnerships and other types of funds.

There appears to be fairly strong resistance, particularly from business people, to the idea of regulating privately placed funds, including the investment business partnerships at the center of the Livedoor incident. Nevertheless, the exemption from disclosure rules for privately placed funds comes from the perspective of protecting the investors that are ultimately solicited to buy the funds. As shown by this latest incident, as long as there is a possibility that the nature of privately placed funds can impact the overall market, then it seems rational, even setting aside for the moment any need to protect those being solicited, to regulate the funds in some way, including by introducing a system of either registration or notification or by conducting unannounced inspections of the funds.

4) System for market oversight is not lacking

Fourth, some observers have taken the view that the Livedoor incident has exposed weaknesses in the current mechanisms for monitoring securities markets. The author regards such a view with a great deal of skepticism, however. In fact, the transition from a preemptive regulatory regime to an ex post administrative monitoring regime initiated with Japan's financial big bang has established firm roots, and the Livedoor incident should probably be viewed as evidence that this market monitoring is properly taking place.

The fraudulent disclosures were exposed roughly one and a half years after they took place. Compared with the murders and kidnappings that so captivate society, it may seem as if it took a long time before the authorities conducted their search, but to the extent that most violations of disclosure requirements are done in such a way that they go undetected at the time, it is unavoidable that considerable time is required to conduct a secret investigation. One past example involving the spreading of market rumors is the well-known TSD incident in which the president of a public company made blatantly false statements at a press conference. From the time of the press conference in August 1992 it took two years and ten months (until June 1995) before indictments were handed down by the Securities and Exchange Surveillance Commission (SESC). Moreover, in the TDS incident, two months after the press conference in early November, the TDS president himself admitted publicly that the information provided at the press conference was false, whereas even to this day Livedoor has yet to acknowledge that its disclosures were fraudulent.

Furthermore, with the special prosecutor's office seeming to take the lead role in the investigation, some observers have suggested that the SESC was somehow not up to the task, but this does not seem to be a very accurate reading of the situation. Although it is certainly the case that the SESC has primary responsibility for uncovering violations of the Securities and Exchange Law, in a case with such important implications for society and in which the suspects needed to be taken into custody quickly, it makes total sense for the commission to work very closely with the special prosecutor's office in pursuing its investigation.

Of course, there is nothing wrong with using the Livedoor incident as a wake-up call to examine whether the SESC is adequately staffed and funded and then strengthen it if necessary. In the process of such examination, it would be wise to think twice before rushing into a simple comparison with the Securities and Exchange Commission (SEC) in the US. The US is a much larger country than Japan, and has a substantially larger securities market, so it is only natural that the SEC would have a larger staff and budget. To attempt to beef up the staff and budget of the Surveillance Commission based purely on a cursory comparison with the US would also be contrary to public opinion, which now favors a smaller government. Any attempt to improve the capabilities of the SESC would require very careful thought, given the multifaceted nature of the organization.

5) Is there a need for the SESC to be independent from the FSA?

In the context of debate over strengthening the SESC, it has also been argued that there is a need for the organization to become completely independent of the Financial Services Agency (FSA). The author, as argued numerous times in the past, does not think that this is necessarily the best approach. Although we want to avoid here repeating our argument in detail, we would like to highlight two particularly important points.

First, the SEC in the US has wide ranging authority, ranging from system planning and writing regulations all the way to uncovering criminal activity, but its purview is limited only to securities markets. Japan's FSA, by contrast, has much broader responsibilities that also include banking and insurance, enabling it to better respond to market conditions in which the barriers between industries are getting lower amid a trend toward large financial conglomerates. To simply mimic the SEC of the US and transfer administration of securities markets to the SESC, and then go on to make the SESC fully independent of the FSA, would probably wind up hurting the organization's ability to respond appropriately.

Second, there are many reasons to doubt the proposition that the format of an independent administrative body like that of the SEC in the US is the most appropriate for an institution that administers and monitors the market. Coordination and negotiation with other government agencies is essential to promoting smooth administration, and thus a greater degree of independence can wind up causing greater isolation, as well. An overemphasis on independence is also questionable from the perspective of democratic control. Even the Financial Services Authority (FSA) in the UK, an exception in that it is organized as a private sector company, is not independent from the government but rather supervised by the Treasury Ministry, and that supervision was strengthened under the Financial Services and Markets Act 2000.

4. Lessons learned from the Livedoor incident

Livedoor and its affiliates, taking the position that they can do anything they please as long as it is not clearly proscribed by the law, used a variety of ruses to repeatedly engage in a money-game-like approach to M&A. They soon wound up crossing the line and engaging in illegal activity, however. The biggest problems were management's attitude and a corporate governance mechanism that was unable to rein that attitude in.

As already explained, however, with the exception of problems relating to the TSE's system, there seem to be virtually no problems with the system itself that require another overhaul in response to the Livedoor incident. In fact, the concern is that the response will be a further tightening of regulations over the short term that winds up inhibiting the sound development of the market.

The UK-based economic daily, The Financial Times, in an editorial dated January 18, 2006 entitled "Japan's old guard tastes revenge," the paper applauded Livedoor's Horie for being a "breath of fresh air" to Japan's corporate community and thus revealing shortcomings in its system. It went on to say that until Japan accepts the fact that free and open financial markets are essential to wealth creation, it will need a lot more Hories – people who dare to bring the system down.

We think it is incorrect, however, to view this incident as the manifestation of a power struggle between the old and new elements within Japan's corporate community. Sparked by the financial "Big Bang" of 1998, the system underpinning Japan's financial and capital markets began a huge shift in direction, away from a preemptive regulatory regime symbolized by the "convoy system" to and ex post administrative monitoring regime. Japan has already established a system rooted in the belief that free and open financial markets are essential to wealth creation. It is probably true that there are more than a few people in the business world who are displeased with Livedoor's behavior, but the company did not become the target of an investigation just because it challenged the old order of Japan's corporate community. Livedoor is being investigated because it is suspected of having engaged in fraudulent, illegal acts. We would very much welcome an uninterrupted stream of bold reformers, but it would be much preferred if they challenged preconceived ideas without resorting to committing fraud and breaking the law.